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# Pensions & Investment Age



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# Ginnie Mae payment delays hurt funds

By Barry B. Burr

Difficulties in recording mortgage-backed securities trades and payments are costing pension funds millions of dollars in potential earnings, fund officials and bank executives acknowledge.

State Street Bank and Trust Co., Boston, lost its largest pension custodial account, the $7.1 billion Teamsters, Central States, Southeast & Southwest Areas Pension Fund, Chicago, over a dispute about uncredited interest on and failed purchases of mortgage-backed securities.

The fund had about $1.1 billion in mortgage-backed securities, including about $666 million in Government National Mortgage Association bonds, as of Dec. 31.

The $7.3 billion Los Angeles County Employees' Retirement Association almost dropped Brown Brothers Harriman & Co., New York, believing the manager was performing poorly. But the problem arose from difficulties Security Pacific National Bank, Los Angeles, the fund's custodian, had in recording payments on the mortgage-backed securities Brown Brothers was managing, according to fund officials.

The fund had $1.1 billion in mortgage-backed securities as of June 30. The fund decided to keep its account with Security Pacific.

Scudder, Stevens & Clark Ltd., Boston, is the largest mortgage-backed securities investment adviser. Keeping track of the securities' payments "is a massive job," said David H. Glen, vice president of Scudder, Stevens.

"Mortgage-backed securities are the worst things banks have to contend with," said Catherine Janson, investment coordinator at Buck Pension Fund Services Inc., New York.

Many problems go unnoticed by pension fund officials. For example, some executives of large pension plans who were interviewed were unable to say how timely their payments are credited to their accounts at their custodial banks.

Because the problems can be costly, many trust departments and pension clients are reluctant to acknowledge them.

Central States first uncovered the problems after a routine audit of the fund by its internal audit staff in late summer 1985, said George W. Lehr, executive director.

The Central States' staff auditors found State Street was not crediting monthly payments on some securities on a timely basis.

Mr. Lehr said the problems continued for months, despite promises by State Street executives to correct them.

"Mechanically, they weren't able to handle it," he said.

The problem was particularly acute because of the rapid paydown in principal by mortgage


*Continued on page 62*

Photo by Michael Marcotte

*Processing Ginnie Mae payments, which must be done manually, is a time-consuming process. At Harris Trust and Savings Bank, Chicago, staff members from other areas are tapped for duty.*

## Inside:


**INTERNATIONAL: Problems with settling trades in foreign countries such as Italy and Spain has caused some institutional investors to pull back from those markets, missing out on market gains — page 37.**

**GOOD SKATE: After making a name for himself in figure skating and broadcasting, Misha Petkevich has successfully glided over to an analyst's job at Wall Street's Hambrecht & Quist — page 53.**

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# CEOs lobbied for pension votes in favor of anti-takeover plans

By Marcia Parker and Joel Chernoff

The chief executives of Rockwell International Corp. and GTE Corp. have sent letters to their Fortune 500 counterparts asking them to lobby their pension executives and money managers to vote in favor of anti-takeover measures.

The letters went out just before special meetings were scheduled at which the two companies' stockholders were being asked to vote on management-sponsored charter amendments designed to ward off raiders.

The changes were approved by wide margins by GTE stockholders Dec. 24 and by Rockwell shareholders Feb. 11.

As of Dec. 31, institutions held slightly more than 50% of both companies' stock, according CDA Technologies Inc., Silver Spring, Md.

*Pensions & Investment Age* obtained copies of the letters, along with a memorandum from well-known takeover lawyer Martin Lipton of Wachtell, Lipton, Rosen & Katz, New York, that he sent to clients in mid-February urging them to follow the lead of GTE's Theodore Brophy and Rockwell's Robert Anderson and "make their views known to their pension fund managers, banks, insurance companies and other institutions."

*The plea by Rockwell's Robert Anderson, left, for corporate executives to lobby their pension funds was heeded by Goodyear's Robert E. Mercer.*

Citing creation of investor groups such as the Council of Institutional Investors and T. Boone Pickens Jr.'s United Shareholders of America, and sponsorship by major pension funds of proxy resolutions attacking "poison pill" provisions, Mr. Lipton said "it has become clear that institutional investors are supporting corporate raiders for the purpose of continuing the junk-bond bust-up takeover frenzy."

In his memo, Mr. Lipton also took one step further a controversial proposal by New Bedford, Mass.-


*Continued on page 61*


# Airline drops dedication

By Fred Williams

FORT WORTH, Texas — American Airlines has liquidated its $1 billion dedicated bond portfolio and set up a dollar duration bond portfolio, correlating the duration of plan assets and liabilities to take advantage of interest rate fluctuations and reduce volatility of pension expenses.

The program is called HALO — hedged asset/liability optimization — by the American pension executives who developed the concept. HALO effectively allows the company to cover its pension liabilities by investing less than half of its $1.7 billion in total defined benefit assets in a special internally managed bond portfolio of longer duration than in the internally managed dedicated portfolio.

Duration is the time it takes for an investor to recover half of the present value of the cash flow of the security.

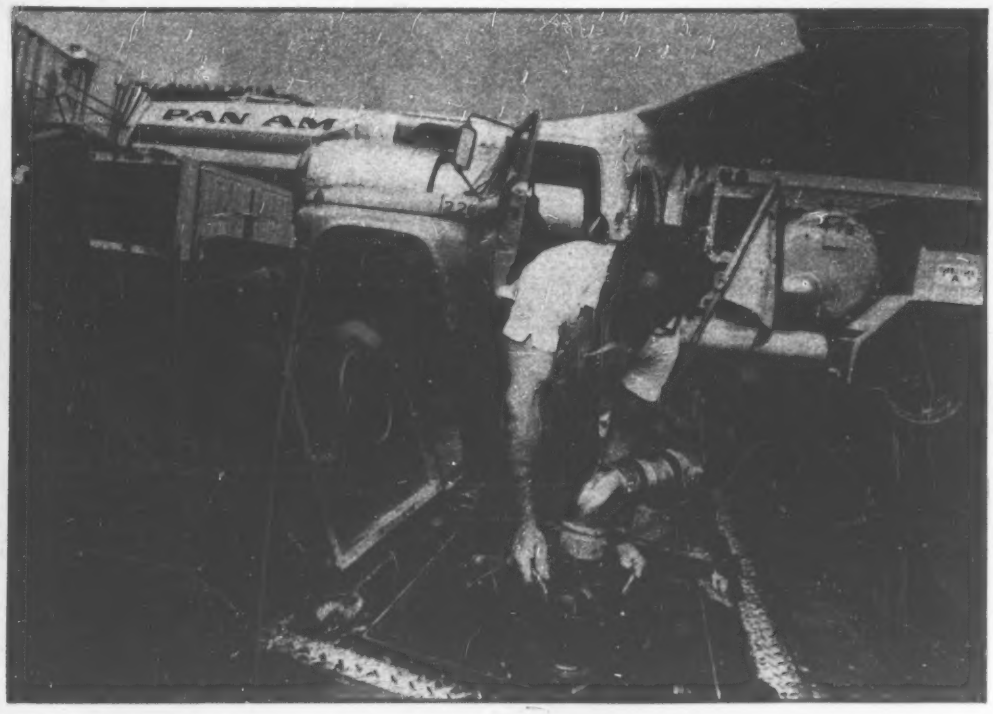
In setting up a dollar duration bond portfolio, the dollar change in the value of the assets and liabilities becomes roughly equal.

The program involved the sale of about $1.05 billion in bonds and the repurchase of some $850 million in long duration bonds, concentrated primarily in government bonds, zero-coupon securities and treasury receipts, said William F. Quinn, assistant treasurer-funds management.

Pension liabilities at American total about $1.7 billion with a duration of 8½ years. The new bond portfolio has a duration of 17 years, he said.

The procedure allowed American to lock in the pension surplus and minimize interest rate risks, said Mr. Quinn. He would


*Continued on page 63*




*The possible purchase of Pan Am by AMR Corp. was grounded in part by a large unfunded liability.*

# Unfunded liability casts pall over Pan Am buy-out

By Fred Williams

FORT WORTH, Texas — Pan American World Airways Inc.'s unfunded pension liability of $670 million was among the major reasons AMR Corp., the parent company of American Airlines Inc., decided in late February not to acquire Pan Am, analysts say.

AMR, Fort Worth, announced late last month it wouldn't bid on New York-based Pan Am after weighing the deal for nearly a month. American and Pan Am exchanged financial and operating data in January.

William F. Quinn, assistant treasurer-funds management at American, said the pension liability was a significant factor in deciding not to pursue the deal.

"Yes, we obviously considered it (the unfunded liability) among other assets and liabilities in determining the overall value of the company," he said.

"It clearly was not a plus factor in assuming a major unfunded liability, but that was only one part of the overall analysis. If there had been other pluses which offset the negatives, the result may have been different," Mr. Quinn said.

"It was only one of many reasons we didn't think it would make sense for us," he said. Other reasons included integrating work forces, the overall value of Pan Am's assets and American's ability to gain access to European routes without Pan Am.

Pan Am's unfunded liability totaled about $670 million as of Dec. 31.

Several analysts agreed the pension liabilities at Pan Am played a significant role in American's decision to walk away from a proposed acquisition of part or all of Pan Am.

"I think it was one of several very important factors," said Julius Maldutis Jr., airline analyst at Salomon Brothers Inc., New York. "I wouldn't place it as *the* most important, but it definitely played a part in the decision."

Other factors were the aging Pan Am fleet and the company's shaky financial condition, including more than $800 million in long-term debt.

Anthony Hatch, airline analyst at Argus Research Corp., New York, said, "Over- or underfunded pension plans certainly are part of the deal and figure into the acquisition fees, even though they are often less obvious. Certainly American must consider all of that and decide if it is cost effective."

Mr. Hatch said Pan Am's unfunded pension liability "will certainly make them hard to sell" since the liability is almost as much as the price of Pan Am's stock. At $6.50 per share, the 136,434 shares of Pan Am stock outstanding would total $887 million.

"Pension costs and liabilities must enter into the calculation of the overall net asset value of the property," said Mr. Hatch.

He characterized the overall financial health of Pan Am as "weak" with "no real obvious prospects of a turnaround."

Except for 1985, the airline has

*Continued on page 62*

# IBM's Shultz to RJR; 4 more switch jobs

Robert E. Shultz, director of U.S. retirement funds at IBM Corp., is joining RJR Nabisco Inc. as vice president-pension asset management.

Separately, three other corporate pension executives and one public fund executive have made job changes.

Philip J. Schneider has left his position as assistant treasurer-employee trusts at Baxter Travenol Laboratories Inc. to take a job at a division of The Wyatt Co. Carolyn Groh, formerly manager-investment administration at Federated Department Stores Inc., has joined Mead Corp. as manager of pension investments. Charles Tharp has left PepsiCo Inc. as director of benefits for its $570 million pension fund. And Layne Denning, executive director, left the Denver Employees' Retirement Plan to become president and chairman of Intermountain Capital Management Inc., Denver.

Other than to say he looked forward to the opportunities at RJR, Mr. Shultz declined to comment on the reasons for his departure from IBM.

Mr. Shultz, who has been at IBM, Stamford, Conn., for almost seven years, will report to Edward J. Robinson, senior vice president and chief financial officer at RJR Nabisco, Winston-Salem, N.C.

Mr. Shultz's appointment requires approval of RJR's board of directors, which is expected to take action March 19, said company spokesman Bill Ruffin. IBM has yet to announce a successor to Mr. Shultz.

Mr. Ruffin declined to comment on how Mr. Shultz's arrival will affect Robert Bennett, president of RJR Investment Management. Mr. Bennett's relationship to others in RJR corporate hierarchy also remains unclear.

When Gene A. Hoots, who was replaced by Mr. Bennett late last year, served as president of RJR Investment Management, he reported to John Dowdle, senior vice president-financial services, who in turn reported to Gwain Gillespie, the chief financial officer.

Mr. Hoots joined Reich & Tang Inc., New York, as a vice president while Messrs. Gillespie and Dowdle retired.

RJR Nabisco has been in transition, consolidating investment managers and developing investment strategy. Several key executives left after the 1985 merger of R.J. Reynolds Industries Inc. and Nabisco Brands Inc., including Messrs. Gillespie, Dowdle and Hoots.

As of Sept. 30, RJR's employee benefit assets totaled $3.2 billion.

Having made his home on Long Island, Mr. Shultz said Winston-Salem will be a big change. Eventually he will be moving to Atlanta, probably in fall, to RJR Nabisco's new headquarters.

Before going to IBM, Mr. Shultz was general financial supervisor of pension funds at New York Telephone Co., and pension funds administration manager at Western Electric Co., both in New York.

He is a member of the board of directors of the Institute for Quantitative Research in Finance and past president of Pension Group East. He is a member of the client advisory board at Chase

*Robert E. Shultz, who directed retirement funds at IBM, has moved to RJR Nabisco.*

Manhattan Bank, the Investment Technology Association, and the committee on investment of employee benefit assets of the Financial Executives Institute.

Mr. Schneider, who begins his new job March 16, will be a consultant in the Chicago office of Wyatt Asset Services Inc., a subsidiary of The Wyatt Co. He reports to Asghar Alam, who is chairman of the asset services practice committee.

His successor at Baxter Travenol has not been named.

As manager of pension investments at Mead, Dayton, Ohio, Ms. Groh will report to Gerald W. Bialka, assistant treasurer. Mead has about $550 million in pension assets.

She replaces Jane Burruss, who

*Continued on page 63*

# Passive equity cut

## Alaska fund transfers $725 million

By Steve Hemmerick

JUNEAU, Alaska — Alaska Permanent Fund Corp. trustees are reducing the fund's passive equity portfolio, part of a move to decrease the fund's equity exposure by $725 million and shift the money into Treasury securities.

The action is the reverse of a long trend by pension plans during the five-year bull market to put increasing amounts into passive equity portfolios. Many fund executives have increased passive management because of disillusionment with active managers' ability to outperform the stock market indexes.

But David Rose, executive director of the $9 billion Alaska fund, expects a drop, or at least a sharp correction, in the market in the coming months, and recommended passive equities be cut because he believes active managers tend to do better than the index in a falling market. He also said he wanted to take profits out of the passive fund.

The approximately $1.3 billion passive portfolio, which tracks the S&P 500, is managed by Bankers Trust — Investment Management Group, New York.

The passive portfolio will retain about $550 million. No money will be taken from the fund's five active equity managers, which manage a total of $550 million.

Mr. Rose noted the Alaska Permanent Fund is conservatively invested. With the additional money shifted into bonds, the asset mix of the fund ultimately will be about 84% fixed income, 4% real estate and 12% stocks, compared

*Continued on page 64*

## Highlights


**CASH MANAGEMENT**
Deal is the real thing ... 31
Utility gets aggressive with cash ... 31
Cash accounts ... 31

**CORPORATE FINANCE**
Mack rolls out $450 million TRUCS ... 47
Leasing OK in spite of tax reform ... 47
Corporate notes ... 49

**INTERNATIONAL**
Index managers get biggest slice ... 37
International update ... 37

**PIPER**
Sector picks pay off in international ... 23
Home-run plan scores ... 23

**REAL ESTATE**
Appraisal guidelines eyed ... 15
Returns decline; assets withdrawn ... 15
Wrap-up ... 15

**GENERAL NEWS**
New asset allocation model developed ... 4
Fund profits, insurer founders ... 6
Managers see end to S&P surge ... 8

**DEPARTMENTS**
Datebook ... 54
Late news ... 66
Letters ... 12
Market beat ... 43
Money movers ... 58
Opinion ... 12
People ... 57
Washington notebook ... 52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## Opinion

# No call for pressure on proxies

PENSION FUNDS SHOULD VOTE their proxies, but they should vote them in the long-term best interests of their beneficiaries. ERISA demands it.

The Employee Retirement Income Security Act requires pension fund assets to be invested solely in the interests of the beneficiaries and, clearly, proxy votes are part of the assets.

Unfortunately, some corporations are attempting to pressure pension executives and managers to vote the proxies in support of proposals to entrench management.

As reported on Page 1 of this issue, a number of letters have been circulated to corporate chief executives enlisting the support of their pension funds in proxy votes in favor of managements that believed themselves vulnerable to takeover bids. Phone calls have been made on other occasions.

In one letter, Martin Lipton, partner in the law firm Wachtell, Lipton, Rosen & Katz, urged all companies to instruct their pension fund managers to vote in favor of charter amendments designed to protect management against "abusive takeover tactics."

Mr. Lipton declared "it has become clear that institutional investors are supporting corporate raiders for the purpose of continuing the junk-bond bust-up takeover frenzy."

In another letter, Theodore F. Brophy, chairman of the board of GTE Corp., suggested other top corporate executives tell the managers of their pension funds to vote for the proposals adopted by GTE's board "if you agree that the proposals will benefit GTE's shareholders in the long run."

The top executives of other companies, who may themselves become targets of unfriendly takeover efforts, are hardly the best-qualified judges of whether the anti-raider proposals of GTE's board are in the long-term best interests of the shareholders.

Corporate pension executives, daily involved in the stock and bond markets, would be better qualified to make a reasoned, unbiased determination on the issue. They also generally pursue the long-term best interests of the pension plan beneficiaries. However, as these letters demonstrate, they may be vulnerable to pressure from top management.

The investment managers, with research resources at their disposal, with an understanding of whether management is doing a good job, and further removed from corporate politics, are the best qualified to decide what is in the long-term best interests of the shareholders and thus the beneficiaries.

Despite Mr. Lipton's intemperate letter, institutional investors are not interested in supporting corporate raiders, or in feeding the "junk-bond bust-up takeover frenzy."

They are interested in getting the best long-term investment results for their clients — in effect, the pension beneficiaries.

Any money managers or pension executives who succumbed to pressure from top management to support with proxy votes another company's top management might find themselves in breach of their fiduciary duties under ERISA.

# A 'half-full' view of the economy

A RECENT REPORT by Polyconomics Inc. provides evidence as to why the economy and the stock market have confounded economists and market analysts who have been predicting doom and gloom.

The economy has performed much better than many analysts give it credit for, the Polyconomics report shows. For example, while many reports suggest the U.S. standard of living has declined in the past five years, the Polyconomics report shows real after-tax income per capita rose 11.3% compared with only 7.5% between 1973 and 1980.

Similarly, reports that U.S. manufacturing industries are dying are premature, the Polyconomics report suggests. It states manufacturing output in the United States increased almost 30% between late 1982 and the end of 1986, a rate exceeding all other major countries. Manufacturing productivity improved 4.1% per year between 1981 and 1985 compared with a 0.9% annual increase in the 1976-1980 period.

From 1980 to 1985 employment in the United States increased by 1.5% annually, 1% in Japan and declined by 0.3% per year in the European Economic Community.

The Polyconomics analysis said the U.S. trade deficit did not indicate the United States was not competitive. The trade deficit did not arise from excessive merchandise imports, which actually declined to 8.7% of gross national product in 1986 from 9.4% in 1980, but from a decline in exports to 5.2% of GNP from 7.9%. The biggest trade problem confronting the United States is that it cannot export to the United States, according to Polyconomics.

The Polyconomics report also had a revisionist interpretation of the "debt crisis," arguing the nation's saving rate was a healthy 19% to 20% of GNP in 1983-'85 compared with 12% to 14% in 1976-'79 and the consumer debt burden was not excessive.

Perhaps investors, like Polyconomics Inc., have been seeing the glass half full while many economists and market analysts have been seeing it as half empty.

## Letters to the editor

### Fund omitted

To the Editor: Omitted from your listing of "Ranking of fund/sponsors" of the top 1,000 pension funds in the Jan. 26 issue of *Pensions & Investment Age* is Southwestern Public Service Co., an investor owned electric utility in Amarillo, Texas.

Pension fund assets for all plans as of Sept. 30, were $250.7 million. Retirement fund assets were $204,414; and stock bonus plans $46.3 million. MBank Dallas is the trustee for retirement fund assets.

**Larry Higgins**
Manager-employee services
Southwestern Public Service
Amarillo, Texas

### Missing data supplied

To the Editor: We were pleased to be included in your scorecard article as the top net business gainer for 1986 of firms between $250 million and $1 billion in assets under management.

Our net new equity business was $378 million and net new balanced accounts totaled $97 million.

**Kenneth S. Grossman**
Partner
Hahn Holland & Grossman
Chicago

### Objects to term use

To the Editor: On the money manager profile questionnaire, question 14 includes the phrase "Dynamic Asset Allocation" — a registered trademark of Leland O'Brien Rubinstein. We would appreciate it if, in future, you acknowledge it as such, or find a substitute phrase such as risk hedging.

**Elaine W. Baker**
Leland O'Brien Rubinstein Associates
New York

### Misattribution alleged

To the Editor: An article in the Jan. 26 issue ("Dedications fall with rates") reports me as saying a recent asset dedication enabled the Western Conference of Teamsters Pension Trust "to wipe out its unfunded liabilities" for purposes of MEPPA. This is a misattribution: I neither said, nor implied, any such thing.

In a telephone interview ostensibly dealing with the trust's asset allocation, I said that dedications enabled the trust to reduce the UVBL significantly.

I neither said it had been "wiped out," nor suggested or implied that doing so was a trust objective.

While the difference may seem unimportant to *Pensions & Investment Age*, I do not appreciate reporters taking liberties with my words, or putting words in my mouth. The error makes me reconsider my willingness to respond to requests for information in the future.

**Alan D. Biller**
Alan D. Biller & Associates Inc.
Palo Alto, Calif.

## Responses due

Questionnaires for *Pensions & Investment Age*'s annual Money Manager profiles issue, to be published May 25, are due March 16.

Investment management executives who want their firms profiled should return their completed questionnaires to Carol Wiley, directory coordinator, *Pensions & Investment Age*, 740 N. Rush St., Chicago, Ill. 60611.

Money managers who have not received questionnaires should contact Ms. Wiley at (312) 649-5486.

The annual Money Manager profiles issue lists almost 1,000 investment advisers, including managers of real estate, international and other alternative investments. The issue includes articles and statistics on the amount of tax-exempt assets managed, investment approaches, investment vehicles used and details of the largest managers.

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# Real Estate

## Wrap-up

### Trust joins in loan

WASHINGTON — The Multi-Employer Property Trust, an open-end commingled real estate fund of Kennedy Associates Real Estate Counsel Inc., Seattle, invested $17.2 million in a participating mortgage loan on the Arboretum Lakes Office Park in Lisle, Ill., a suburb of Chicago.

The trust is a co-investor with the $8 billion Alaska Permanent Fund Corp., Juneau, a trust for a portion of state royalties from Alaskan mineral rights.

The Alaska trust will invest $11.5 million in the mortgage.

Landon Butler, a member of the multi-employer trust's policy board, said his trust's investment in the participating mortgage will yield a 10.5% cash on cash return, and an estimated internal rate of return of 14% over the next 10 years. The rate of return is higher than many other current ones because the commitment was made more than a year ago, when interest rates on such loans were higher, Mr. Butler said.

"With the funding of Arboretum Lakes, we will have invested a total of $30 million in five Chicago office park properties," he noted.

"The trust's targeted Chicago investments are designed to accomplish two key objectives. First, by investing in high-quality properties in one of the nation's top office markets, the trust is meeting its long-term investment objectives. Second, we enable our Chicago-based clients to reinvest their pension fund assets in their home region," he added.

Three of the 83 pension funds in the trust are Chicago funds: the $390 million Chicago District County of Carpenters Pension Fund; the Laborers Pension Fund; and the Iron Workers Mid-America Pension Fund.

### Teachers finance mall

AUSTIN, Texas — The Teacher Retirement System of Texas has made a $52 million mortgage on Southwest Plaza Mall in Jefferson County, Colo., the largest mall in that state.

The two-level regional mall, with 1.2 million square feet, is 12 miles southwest of Denver's central business district.

The investment was made through one of the $16 billion retirement system's advisers, L.J. Melody Co., Houston, which services and manages real estate investments.

### Mall partnership set

DALLAS — A closed-end limited partnership fund that invests solely in retail shopping centers is being marketed by Lehndorff & Babson Real Estate Counsel, Dallas.

According to G. Andrews Smith, president of Lehndorff & Babson, the fund is the only one to be entirely in shopping center investments.

The fund will share investments with Lehndorff & Babson's separate account clients and thereby allow the fund to invest in several large centers, each of which will have a minimum of 800,000 square feet. The fund, which is expected to close in about 12 months, will have total assets of $75 million to $100 million.

*Continued on page 18*

# Appraisal guidelines eyed

**By John Covaleski**

In an effort to bolster pension fund executives' confidence in real estate investing, leading industry groups are pressing real estate managers to take more responsibility for the real estate appraisal process.

The National Council of Real Estate Investment Fiduciaries, New York, has proposed guidelines for how real estate managers should contract with appraisers and direct their work. The Pension Real Estate Association, Washington, is interested in using the NCREIF proposal to establish its own guidelines.

NCREIF's members are real estate managers with more than $20 billion under management from pension funds. PREA's members are both pension funds and managers whose investments in real estate account for more than $100 billion.

In another development, James A. Graaskamp, a University of Wisconsin professor who led a PREA-funded study that found widespread errors in appraisals of pension fund-held real estate, has spoken out strongly for regulating managers in the hiring of appraisers.

"My belief is that if something (establishing guidelines) isn't done, it will lead to problems for asset managers. It could make plan sponsors squeamish about real estate," he said.

Mr. Graaskamp's 1986 study of more than 50 appraisals of properties in commingled funds determined the properties can be significantly undervalued or overvalued because appraisals in general lack necessary information and appraisal methods are inconsistent (*Pensions & Investment Age*, Dec. 8).

Real estate investment managers are in most cases solely responsible for the appraisal of their commingled fund properties, either by performing appraisals with their own staff or contracting the duties of third-party appraisers. It is generally believed that establishing guidelines for contracting the service would give pension executives and other investors in real estate funds a better understanding of the appraisal process.

NCREIF's proposed "Guideline For Preparation Of An Appraisal Engagement Letter" would require that real estate managers who serve as fiduciaries, in drafting agreements with appraisers, include the methods and procedures to be used in the appraisals. The proposal also sets guidelines for other terms in engaging appraisers and requires that minimum standards be established for the appraisers' work.

*"My belief is that if something isn't done, it will lead to problems for asset managers. It could make plan sponsors squeamish about real estate."*

— James A. Graaskamp

Mark Decker, executive vice president of PREA, commended the NCREIF proposal saying, "There's a strong feeling among our leaders to adopt rules similar to theirs."

PREA President Kenneth Campia, president of LaSalle Advisors Inc., Chicago, said he expects standardization to come to the appraisal industry, but he has reservations about adopting a policy requiring managers to direct how appraisals are done. "You don't want appraisals to be client-driven," he warned.

Robert Smedley, NCREIF president and president of Wachovia Real Estate Fund, Winston-Salem, N.C., said NCREIF has no power to enforce the guidelines on its members, but he hopes the members adopt the proposal and follow it voluntarily. He said the guidelines are necessary to make the appraisal process "more credible" to pension executives.

The appraisal industry's reputation was seriously wounded last year when a congressional subcommittee investigation found many incorrect appraisals.

As a result of that study, the subcommittee of the House's Committee of Government Operations isdrafting legislation that would establish a "self-regulatory organization" within the appraisal industry. That organization would be responsible for licensing, testing and setting work standards for appraisers.

But Mr. Graaskamp, who has been described as one of the country's foremost appraisal experts, said, "The problem is with the employers of appraisers, not with the appraisers. Any regulatory system that fails to place sanctions against the employers is doomed to fail."

Irregularities in the appraisal industry are caused by appraisers' "willingness to satisfy their employers," as much as by the appraisers' negligence, he said. He did not name any specific cases, but said managers trying to increase their portfolio asset sizes sometimes pressure appraisers to misstate appraisals.

Mr. Graaskamp wants managers to be given guidelines in the method of contracting appraisers, dictating certain aspects of how the appraisals should be done, and in evaluating appraisers' work.

The board of directors of PREA, concerned about giving fiduciaries too much input in the appraisal process, earlier this year voted not to accept Mr. Graaskamp's recommendations. Mr. Decker said despite that rejection, the association feels some standardization of appraisals, such as the NCREIF proposal, is needed.

Interviews with real estate managers showed lack of uniform appraisal methods is of greatest concern. David Glickman, president of Heitman Advisory Corp., Chicago, said: "If appraisals are not uniform, plan sponsors cannot fairly compare the real estate products available to them."

# Returns decline; assets withdrawn

**By Steve Hemmerick**

Investment returns for some large open-end commingled real estate funds continued to slide for periods ended Sept. 30, Pensions & Investments' Performance Evaluation Report results show.

At the same time, some pension executives are continuing to withdraw assets from some of the commingled funds.

PRISA, the largest open-end fund, which is offered by Prudential Asset Management Co. and managed by Prudential Realty Group, Newark, N.J., reported a 7% return for the 12 months ended Sept. 30, down about 2.7 percentage points from the 9.7% previous 12 months ended Sept. 30, 1985.

Clients of the Prudential Real Estate Investment Separate Account took out $1 billion from the fund during calendar year 1986. The fund ended Dec. 31 with $4.76 billion in assets, down from $5.32 at the beginning of the year.

The reason that the fund hasn't dropped $1 billion in assets is because the fund generated $332 million in income and $73 million in new contributions. The biggest cash outflow for 1986 was in the fourth quarter, when about $350 million was taken out by clients, according to Richard Merrill, the new chairman of Prudential Asset Management.

Mr. Merrill said preliminary estimates indicate in the first quarter of 1987, clients will take out an estimated $150 million in additional assets. He said Prudential officials think this may be an indication that the large outflows of cash are now being reduced.

He said the money taken out is partly because of plan reversions and because people have been bullish about stock market returns.

However, he said investors are becoming edgy about the market and this is contributing to part of the reduction in asset outflow. He also thinks the fund has new appraised values that present opportunistic buys for investors.

Although assets of the Prime Property Fund, the second largest open-end fund and offered by Equitable Life Assurance Society of the United States, New York,

*Continued on page 16*

## Real Estate open-end funds

**Periods ended Sept. 30**

**1-year returns**

| | % |
|---|---|
| Citicorp, N.Y. | 23.0 |
| Chase Manhattan, N.Y. | 18.3 |
| Morgan Guaranty, N.Y. | 17.2 |
| Copley (Dev. Prop.), Mass. | 17.2 |
| Canada Life Assurance | 15.1 |
| Union Labor Life (J), D.C. | 14.2 |
| Prudential (MORISA) | 12.9 |
| Bank One Trust Columbus, Ohio | 12.8 |
| Wells Fargo Realty, Calif. | 12.2 |
| Prudential (PRIMOR) | 12.1 |
| Phoenix Mutual, Conn. | 11.8 |
| Bank of Boston, Mass. | 11.1 |
| NCNB Nat'l Bank, N.C. | 10.9 |
| Aetna Life & Cas. (PMSA), Conn. | 10.7 |
| Third Nat'l Nashville, Tenn. | 10.4 |
| Harris Trust (Inc. Prop. F), Ill. | 10.3 |
| CIGNA Corp., Conn. | 10.1 |
| Travelers, Conn. | 9.8 |
| Chemical Bank, N.Y. | 9.2 |
| Equitable Life (Prime Prop.), N.Y. | 8.8 |
| Aetna Life & Cas. (RESA), Conn. | 8.6 |
| Massachusetts Mutual | 8.6 |
| Southland Trust (SREEF), Texas | 8.4 |
| Sun Bank, Fla. | 8.3 |
| Principal Mutual Life, Iowa | 8.2 |
| Wachovia Bank, N.C. | 8.0 |
| Metropolitan Life (Tower), N.Y. | 7.2 |
| First of Chicago (F), Ill. | 7.1 |
| Prudential (PRISA) | 7.0 |
| Metropolitan Life, N.Y. | 6.0 |
| First of Minneapolis, Minn. | 5.4 |
| Lloyds Bank (F), Calif. | 5.4 |
| Mutual Benefit (VCA-5), N.J. | 4.4 |
| **Consumer Price Index** | **1.8** |
| RepublicBank, Dallas | 1.3 |
| John Hancock, Mass. | 0.2 |
| InterFirst Bank Dallas | −0.7 |
| Seafirst Bank, Wash. | −2.8 |

**3-year returns**

| | % |
|---|---|
| Copley (Dev. Prop.), Mass. | 19.3 |
| Phoenix Mutual, Conn. | 16.6 |
| Chase Manhattan, N.Y. | 16.2 |
| Citicorp, N.Y. | 16.0 |
| Prudential (MORISA) | 16.0 |
| Canada Life Assurance | 14.9 |
| Prudential (PRIMOR) | 14.9 |
| NCNB Nat'l Bank, N.C. | 14.6 |
| Metropolitan Life, N.Y. | 14.5 |
| Morgan Guaranty, N.Y. | 14.4 |
| Union Labor Life (J), D.C. | 14.3 |
| Mutual Benefit (VCA-5), N.J. | 14.1 |
| Southland Trust (SREEF), Texas | 13.7 |
| CIGNA Corp., Conn. | 12.9 |
| Equitable Life (Prime Prop.), N.Y. | 12.9 |
| Aetna Life & Cas. (PMSA), Conn. | 12.7 |
| Bank One Trust Columbus, Ohio | 12.4 |
| Metropolitan Life (Tower), N.Y. | 12.2 |
| Wachovia Bank, N.C. | 11.9 |
| Bank of Boston, Mass. | 11.7 |
| First of Minneapolis, Minn. | 11.3 |
| Wells Fargo Realty, Calif. | 11.2 |
| Chemical Bank, N.Y. | 11.2 |
| Harris Trust (Inc. Prop. F), Ill. | 11.1 |
| Aetna Life & Cas. (RESA), Conn. | 11.0 |
| Massachusetts Mutual | 10.5 |
| Sun Bank, Fla. | 10.5 |
| Principal Mutual Life, Iowa | 10.5 |
| Prudential (PRISA) | 10.3 |
| First of Chicago (F), Ill. | 10.2 |
| Third Nat'l Nashville, Tenn. | 9.7 |
| Travelers, Conn. | 9.2 |

*Continued on page 16*

# Returns drop . . .

*Continued from page 15*

have remained stable at between $2.8 billion and $2.9 billion during year ended Sept. 30, returns are dropping. The fund returned 8.8% for the year ended Sept. 30, vs. 11.9% the 12 months ended Sept. 30, 1985.

According to PIPER figures, the John Hancock Real Estate Separate Account reported a 0.2% return for the 12 months ended Sept. 30, down 7 percentage points from the 7.2% return during the previous 12 months.

Returns for all three funds are below a median of 9.5% for 90 open- and closed-end real estate funds with $26 billion total assets for the year ended Sept. 30. This median was provided by Evaluation Associates Inc., Westport, Conn.

The lower returns largely are due to depreciation of assets rather than loss of income yield, managers and consultants say.

The break out of the PRISA return, for example, shows relatively stable income yields, but declining appreciation. For the 12 months ended Sept. 30, PRISA had an income return of 7.01% but an appreciation return of −0.5%. In the 12 months ended Sept. 30, 1985, the return on income for PRISA was 7.2%, but the appreciation return was 2.4%.

Returns may be sliding because real estate managers have been slow to react to current market conditions, such as asbestos problems, increasing vacancies and declining rents, suggested Paul Saylor, a principal with Institutional Property Consultants, Atlanta.

What is seen today in stable or declining appreciation for many properties, he said, is a proper adjustment to offset past optimism.

Problems could multiply for some open-end fund managers because poor performance could set off a new wave of withdrawals.

Mr. Saylor said investors "should be encouraged by the fact that the large open-end fund managers are showing a great deal more realism than they have in the past," while performance is "not getting to the area of extreme concern when people should again try to take money out in mass quantities."

Unit values for open-end funds "are getting into the range where they might represent some pretty decent buys," he added.

Income for many of the commingled real estate funds remains above the U.S. Consumer Price Index, which increased 1.8% for the 12-month period.

And a key reason for being in real estate — to help stabilize returns for portfolios — hasn't changed, pointed out Tina Brownley, a director at Prudential.

She said the real rate of return has been positive for PRISA since it began in 1970.

Not every fund suffered during the 12 months ended Sept. 30. Citicorp Real Estate Equity Fund, offered by Citicorp Investment Management Inc., New York, had the highest one-year return — 23% — of any fund in PIPER. Yet for the year ended Sept. 30, 1981, when most real estate funds were scoring returns in the teens, the Citicorp fund was in the last decile with a 5.9% return.

Citicorp moved out of the basement beginning with the 12 months ended Sept. 30, 1985, primarily because of rent increases. It also realized gains from the sale of two buildings, said H. Piper Andrews Jr., a vice president with Citicorp. The office buildings, in the Century City area of Los Angeles, were sold for $230 million to Japanese investors last year. That same year, Citicorp refinanced an office building at 633 Third Ave., New York, that produced another $96 million in cash.

Mr. Andrews said the New York building is appreciating sharply because 300,000 square feet of space is being re-leased at $27 to $30 per square foot from $10. Citicorp originally bought into the building because fund officials believed the low rents could be raised by buying out old leases.

He said the fund is using the cash to make a "major play" in retail properties and industrial buildings.

Other open-end funds with high returns for the year ended Sept. 30 were Chase Investors Management Corp., New York, Chase Bank Real Estate Investment Fund, with an 18.3% return; J.P. Morgan Investment Management Inc., New York, Commingled Pension Trust Fund, 17.2%; and Copley Real Estate Advisors, Boston, Developmental Properties Account, 17.2%.

The closed-end fund with the highest return is JMB Institutional Realty Corp., Chicago, Group Trust No. 1, which returned 18.1% for the 12 months ended Sept. 30.

Managers of the JMB fund, which has $319 million in net assets, decided five years ago to put the majority of the assets in retail space, said Ted Stern, an executive vice president with JMB.

The fund is 57% in retail properties, while the average fund has about 23% of assets in retail, Mr. Stern said.

Other closed-end funds with high returns for the 12 months ended Sept. 30 were: Equitec Institutional Realty Advisers, Oakland, Calif., Fund No. 1, with a 16.1% return, and Lehndorff & Babson Real Estate Counsel Inc., Dallas, Lehndorff & Babson Property Fund, with a 17.1% return.

For five years ended Sept. 30, the Morgan Guaranty Fund has the highest return among open-end funds, 17.6% compounded annually. It also has the highest 10-year return at an annualized 19.1%.

Among closed-end funds, JMB Group Trust No. 1 had the highest return of an annualized 16.9% for five years; Colowell Banker Capital Management Services, New York, Institutional Fund No. 1, had a high return of 20.6% compounded annually for the 10-year period. It is the only fund reported in the PIPER 10-year universe. ■

*Continued from page 15*

| | |
|---|---|
| InterFirst Bank Dallas, Texas | 8.3 |
| RepublicBank Dallas, Texas | 7.4 |
| Lloyds Bank (F), Calif. | 7.2 |
| John Hancock, Mass. | 6.9 |
| Seafirst Bank, Wash. | 4.4 |
| **Consumer Price Index** | **3.1** |

### 5-year returns

| | % |
|---|---|
| Morgan Guaranty, N.Y. | 17.6 |
| Union Labor Life (J), D.C. | 16.6 |
| NCNB Nat'l Bank, N.C. | 15.8 |
| Phoenix Mutual, Conn. | 15.6 |
| Southland Trust (SREEF), Texas | 15.5 |
| Chase Manhattan, N.Y. | 15.4 |
| Aetna Life & Cas. (PMSA), Conn. | 15.1 |
| CIGNA Corp., Conn. | 14.7 |
| Canada Life Assurance | 14.4 |
| Prudential (PRISA) | 14.4 |
| Chemical Bank, N.Y. | 13.7 |
| Metropolitan Life, N.Y. | 13.6 |
| Bank One Trust Columbus, Ohio | 12.8 |
| Bank of Boston, Mass. | 12.5 |
| Metropolitan Life (Tower), N.Y. | 12.3 |
| First of Minneapolis, Minn. | 12.2 |
| Citicorp, N.Y. | 12.2 |
| Equitable Life (Prime Prop.), N.Y. | 12.1 |
| First of Chicago (F), Ill. | 11.9 |
| Massachusetts Mutual | 11.4 |
| Wachovia Bank, N.C. | 11.2 |
| Sun Bank, Fla. | 11.1 |

*Continued on page 18*

At NCNB,
We Follow The Philosophy
Of The Pharaohs.

They knew two things were critical to solid real estate investments. Quality construction and teamwork. Given the enduring results of that way of thinking, NCNB insists on it too.

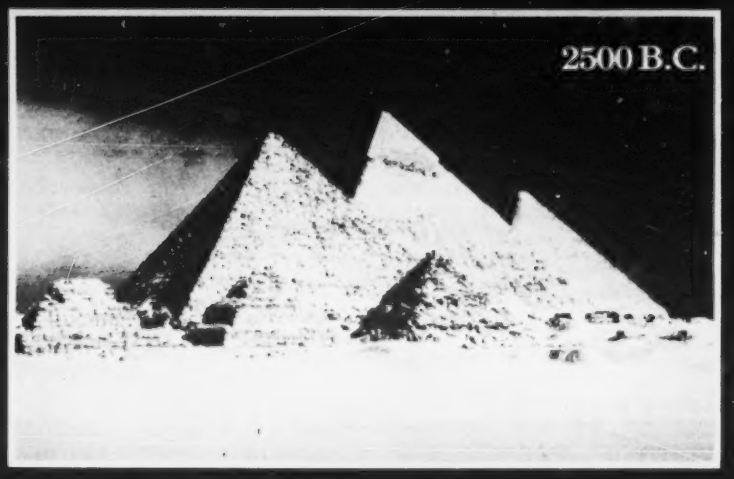
Our experienced team of development, architectural, construction, and property management specialists work exclusively with high-quality properties, located primarily in the Southeast. And our dedication to quality and teamwork has paid substantial dividends.

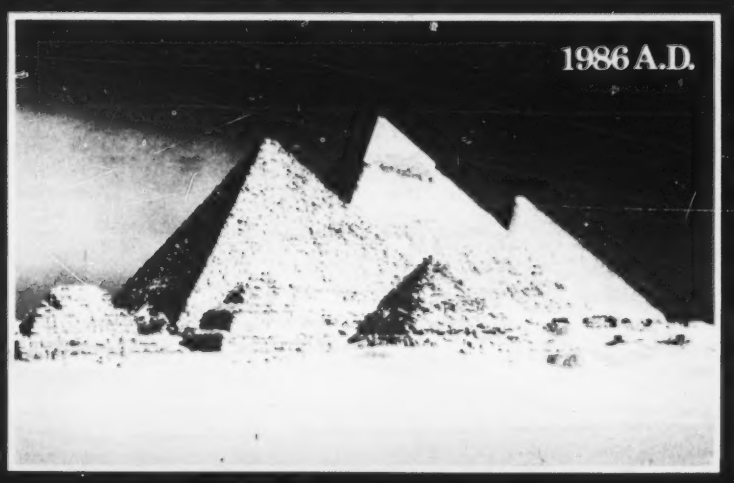
With consistently high returns, the NCNB Real Estate Fund has climbed to the peak of the industry in recent years. We've cemented our place at the top of the open-end fund universe with an average annual return of 16.4%* over the last five years. Our ten-year average is just as impressive.

Many real estate investments may look good in the short run, but The NCNB Real Estate Fund has passed the ultimate test...the test of time. Call Mark Coltrin, NCNB Trust Group Vice-President for details at (704) 374-8405.

*As reported by CDA Investment Technologies, Inc. for the period ending 12/31/85.

NCNB




NCNB
REAL
ESTATE
FUND

## Wrap-up

*Continued from page 15*

The new partnership fund will focus on "vintage" shopping centers that can be renovated for added return.

Also, he said, Lehndorff will do all its own property management on the centers it buys.

Mr. Smith said the fund "is a major move for us, and it will be for investors as well because well-managed shopping centers have shown time and again to be attractive investments, both in terms of risk and value added."

## L.A. prices near high

LOS ANGELES — Prices of Los Angeles real estate, supported by the city's booming economy, are at upper levels, according to a report by Salomon Brothers Inc., New York.

For Los Angeles real estate to generate the returns the investors expect, the report said, the Los Angeles economy must continue to perform as well, or nearly so, as it has in the past.

The report suggests caution because the Los Angeles area economy is facing some risks. The report said defense spending growth, an important part of the Los Angeles economy, is slowing. The city area has also benefited from imports that will probably decline with the value of the dollar.

But while returns on property there could decrease, the report said prices for Los Angeles real estate are expected to remain high, partly because of Los Angeles' growing importance as an international city and its economic connections with Tokyo.

Despite the presence of rent control in some areas of the Los Angeles basin, apartment fundamentals appear to be better in the Los Angeles area than other parts of the country, the report said.

## Trouble spots noted

NEW YORK — There are some "truly troubled" office markets, including Dallas, Denver, Houston, New Orleans and Oklahoma City, according to a 1987 real estate market forecast by Landauer Advisors Inc., New York.

Those cities' office markets are not likely to regain their real estate or general economic balance until the 1990s, the forecast said.

"The indication that Texas is experiencing net migration out of state for the first time in its history aptly suggests that this message has been received and understood by the general population," the report noted.

But the report said office market conditions vary among the nation's cities.

New York City, for example, has steady office rents and below-average vacancy rates. But downtown Manhattan, with a 9% office vacancy rate, is experiencing its most intense competition for tenants since New York's economic recovery in the late 1970s.

The report also said the amount of vacant office space in Chicago and Los Angeles is rising.

According to the report, investors are presently focusing on established regional malls. But the report said, shopping centers, like hotels, are management intensive and require strong merchandising ability, detailed maintenance and close security.

Retail markets in the Northeast, from New England through Washington, are star performers in retail property; the retail markets in Southern California are also outstanding.

As for industrial properties, the report noted there is a slowly rising level of vacancies, and properties should be approached selectively.

*Continued from page 16*

| | |
|---|---|
| Aetna Life & Cas. (RESA), Conn. | 10.9 |
| Wells Fargo Realty, Calif. | 10.9 |
| InterFirst Bank Dallas, Texas | 10.1 |
| Third Nat'l Nashville, Tenn. | 9.8 |
| Prudential (PRISA) | 9.7 |
| RepublicBank Dallas, Texas | 9.4 |
| Travelers, Conn. | 9.3 |
| John Hancock, Mass. | 8.5 |
| Seafirst Bank, Wash. | 7.1 |
| **Consumer Price Index** | **3.3** |

**10-year returns** %

| | |
|---|---|
| Morgan Guaranty, N.Y. | 19.1 |
| Wachovia Bank, N.C. | 14.9 |
| Prudential (PRISA) | 14.4 |
| Metropolitan Life, N.Y. | 13.5 |
| Equitable Life (Prime Prop.), N.Y. | 12.8 |
| Wells Fargo Realty, Calif. | 12.7 |
| Bank of Boston, Mass. | 12.3 |
| First of Chicago (F), Ill. | 12.0 |
| Travelers, Conn. | 12.0 |
| **Consumer Price Index** | **6.7** |

## Real Estate closed-end funds

**Periods ended Sept. 30**

**1-year returns** %

| | |
|---|---|
| JMB Institutional (Gr. Tr. I) | 18.2 |
| Lehndorff & Babson (Prop.) | 17.2 |
| TCW Realty Advisors (II), Calif. | 17.0 |
| Equitec (I), Calif. | 16.1 |
| TCW Realty Advisors (I), Calif. | 15.5 |
| John Hancock (SERA 1), Mass. | 15.4 |
| RREEF (Mid-Am. III) | 14.6 |
| State Street Bank (I), Mass. | 14.4 |
| Landauer Advisors (I), N.Y. | 14.2 |
| LaSalle Advisors (LSF), Ill. | 13.5 |
| JMB Institutional (Gr. Tr. II) | 13.2 |
| Aetna Life & Cas. (CERESA I) | 11.8 |
| RREEF (West VI) | 11.5 |
| RREEF (West III) | 11.4 |
| RREEF (USA I) | 10.6 |
| RREEF (Mid-Am./E. IV) | 10.5 |
| JMB Institutional (Gr. Tr. III) | 10.1 |
| CIGNA Corp., Conn. | 10.1 |
| Aetna Life & Cas. (CERESA II) | 9.8 |
| RREEF (West II) | 9.7 |
| Equitable Life (New Prop.), N.Y. | 9.7 |
| Metropolitan Life (II), N.Y. | 9.6 |
| RREEF (West I) | 9.4 |
| State Street Bank (II), Mass. | 9.3 |
| RREEF (West V) | 9.2 |
| Metropolitan Life (I), N.Y. | 9.1 |
| Sarofim Trust Co. (SIRF P-I) | 9.0 |
| RREEF (Mid-Am. II) | 9.0 |
| Coldwell Banker (Inst. II) | 7.5 |
| Coldwell Banker (Inst. IV) | 7.3 |
| RREEF (Mid. Am. I) | 7.1 |
| RREEF (USA III) | 7.1 |
| Coldwell Banker (Inst. VI) | 6.8 |
| State Street Bank (III), Mass. | 6.7 |
| RREEF (West IV) | 6.0 |
| Coldwell Banker (Inst. VIII) | 6.0 |
| Coldwell Banker (Inst. III) | 5.3 |
| RREEF (USA II) | 3.5 |
| Coldwell Banker (Inst. V) | 3.4 |
| **Consumer Price Index** | **1.8** |
| Coldwell Banker (Inst. VII) | – 2.0 |

**3-year returns** %

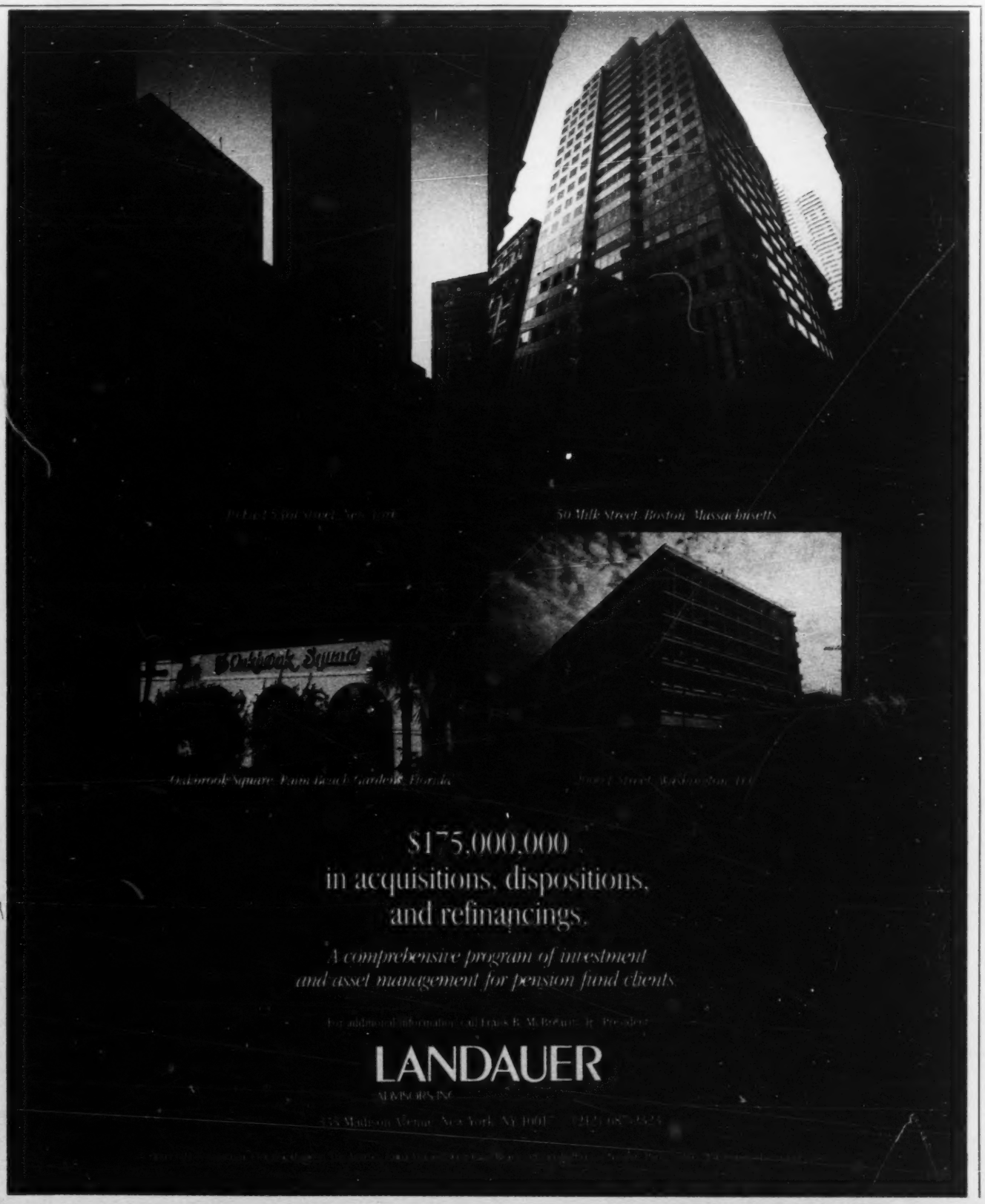
| | |
|---|---|
| JMB Institutional (Gr. Tr. I) | 18.7 |
| State Street Bank (I), Mass. | 16.3 |
| LaSalle Advisors (LSF), Ill. | 15.8 |
| Aetna Life & Cas. (CERESA I) | 15.5 |
| Sarofim Trust Co. (SIRF P-I) | 15.0 |
| Coldwell Banker (Inst. V) | 15.0 |
| Equitable Life (New Prop.), N.Y. | 13.0 |
| Coldwell Banker (Inst. II) | 12.5 |
| RREEF (West III) | 12.4 |
| RREEF (Mid-Am. II) | 12.2 |
| RREEF (West II) | 11.4 |
| RREEF (USA I) | 10.7 |
| CIGNA Corp., Conn. | 10.6 |
| RREEF (USA II) | 9.9 |
| Coldwell Banker (Inst. IV) | 9.4 |
| RREEF (West I) | 9.2 |
| Coldwell Banker (Inst. VI) | 9.0 |
| Coldwell Banker (Inst. III) | 8.6 |
| RREEF (West IV) | 8.0 |
| RREEF (Mid. Am. I) | 7.5 |
| Coldwell Banker (Inst. VII) | 7.4 |
| **Consumer Price Index** | **3.1** |

**5-year returns** %

| | |
|---|---|
| JMB Institutional (Gr. Tr. I) | 16.9 |
| LaSalle Advisors (LSF), Ill. | 15.5 |
| Coldwell Banker (Inst. II) | 15.3 |
| Coldwell Banker (Inst. V) | 14.3 |
| RREEF (West II) | 12.3 |
| RREEF (West I) | 12.1 |
| Coldwell Banker (Inst. IV) | 12.0 |
| Coldwell Banker (Inst. VI) | 10.1 |
| Coldwell Banker (Inst. III) | 9.5 |
| **Consumer Price Index** | **3.3** |

**10-year returns** %

| | |
|---|---|
| Coldwell Banker (Inst. II) | 20.6 |
| **Consumer Price Index** | **6.7** |



**PIPER**

*The statistical data are extracted from Pensions & Investments' Performance Evaluation Report, a quarterly performance evaluation published by* Pensions & Investment Age. *PIPER details comparative performance data on special equity and international funds at more than 50 banks and insurance companies. PIPER is compiled by Rogers, Casey & Barksdale Inc., Stamford Conn.*

# Sector picks pay off in international

**By Marlene Givant**

To 1986's top-performing international managers, picking profitable industrial sectors was almost as important as country weighting, Pensions & Investments' Performance Evaluation Report shows.

Most managers cut back on Japanese investments during the year, but because of the yen's strength, some remain bullish on Japanese industries oriented toward domestic demand.

Similarly, the jump in the deutsche mark is causing some managers to reduce exposure to West Germany while others are attempting to overweight domestic-oriented German companies.

The Continent was a good play in 1986 but growth of Europe's more mature markets might slow this year, managers predicted.

According to PIPER, the top-ranked manager of a commingled international fund for the one- and three-year periods ended Dec. 31 was BA Investment Management International Ltd., London, with walloping returns of 97.7% and a compound annual 44.3% for those periods, respectively, on its $55 million International Employee Benefit Equity Fund.

Ranked second for the year and third for the three years was American National Bank & Trust Co., Chicago, with 75.1% and a compound annual 42.1%, respectively, on its $21 million International Equity Fund.

Bessemer Trust Co., New York, ranked third for the year with a 75% return on its $85.9 million Fund E Equity vehicle and Marine Midland Bank's, New York, $30 million International Equity Fund, managed by Wardley Investment Services International, New York, ranked fourth with 73.9%.

These were the only international pooled funds of the 28 that PIPER tracks to beat the Morgan Stanley Capital International Europe Australia Far East index's 70% return in 1986. Centerre Trust Co. of St. Louis, was just below the index with a 69.4% return for the year.

For the three years, only BA beat the EAFE index's annualized 42.2% return, and for five years, IDS International Inc.'s, Minneapolis, International Collective Equity Fund of $59.5 million with an annualized return of 30.8% and BA with a 30.1% return, narrowly beat the index's 28.8%.

During the fourth quarter of 1986, in contrast, 18 out of 28 international managers in the PIPER universe outperformed the EAFE, which returned only 4.2%.

Ranked first for the quarter with an 8.9% return was Provident National Assurance Co.'s, Chattanooga, Tenn., International Low P/E Equity Fund, managed by Provident Capital Management Inc., Philadelphia.

Marine Midland's fund was second with an 8% return and IDS International's fund returned 7.2%.

BA Investment Management looks at consensus expectations of international market prices, levels of growth, earnings, interest rates, currencies and political and policy trends over a 12-month time horizon.

Portfolios are structured to add value where the firm's expectations differ from the consensus. Stocks are chosen the same way. Individual markets and sectors are emphasized equally and currency risk is managed entirely separately using forward contracts.

"In all world markets we saw a heavy emphasis — with only minor diversions — on the same broad sectors as the best performers across all markets: financials, services, consumer goods. Basic industry sectors, on the other hand, had poor performance," said John Horseman, investment manager.

"Earnings growth in 1987 will be somewhat short of expectations. In Japan, earnings are likely to decline, partly due to the dollar's decline, particularly in certain industries. We tend to find better value in other markets."

Since early last year, the firm reduced its Japanese exposure to 10% at year-end from less than 30%. It now stands at 5%.

**Open- and closed-end real estate fund results - page 15**

The firm's scant holdings in Japan during 1986 were in finance-oriented companies and asset-based sectors, which significantly outperformed the Japanese market.

Globally, "we still hold the view that the U.S. economy will muddle along. Germany and Japan will have stable to low interest rates. Disinflation continues to favor the stocks and the sectors we're in."

BA likely will be overweighted in West German financial and consumer food stocks this year. "Earnings in Germany will probably be down 10% this year," Mr. Horseman said. "Automobile, capital goods and machinery industries will be hurt by the deutsche mark increasing and the flat world economy."

The Spanish market appears to have reasonable values and the United Kingdom has strong potential, he said.

"We're still keen on the U.K. — consumer sectors, high wage growth, strong background in consumer credit, domestic-based companies benefiting from the weaker sterling. There's a lot of similarity with our position last year," said Mr. Horseman.

BA also might explore smaller Southeast Asian markets — such as Korea or Thailand — partly because Japan is establishing alternative manufacturing facilities there, Mr. Horseman added.

American National Bank, which manages $30 million in assets for U.S. tax-exempt clients, runs a diversified international equity fund using index fund principles. It was able to beat the EAFE last year because the firm curbs excessive trading costs, which are especially high in international investing. But holdings in the fund are not rebalanced as frequently as holdings in a traditional index fund, said Steve Manus, vice president at American National Bank.

In addition, the fund doesn't hold stock in every country included in the EAFE. "Some are small and trading costs are high," Mr. Manus said. "They don't add much value."

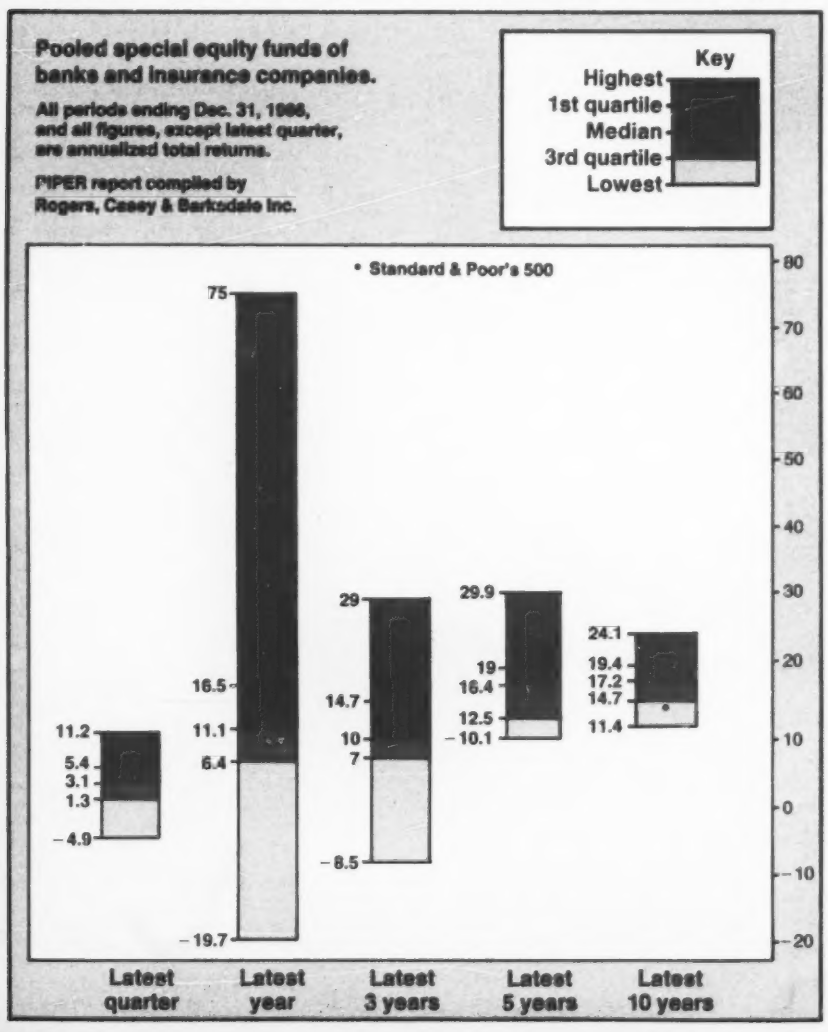
Bessemer Trust reduced its exposure to Japan in 1986, shifting instead to the European continent.

"We had a larger position (than the EAFE) in Italy and Spain and continued our emphasis on domestic companies in Japan. By the end of the year, we were taking profits in Japan and putting them into Hong Kong and Australia," said Jane N. Abitanta, assistant vice president.

The firm did not like the United Kingdom through most of 1986. But in the fourth quarter, with the country's strong consumer spending and weaker pound, Bessemer increased its weighting there.

"We're bullish on the Continent. We reduced the U.K. weighting through 1986 shifting emphasis to Belgium and Spain.

*Continued on page 24*




# Home-run plan scores

## Managers in small-cap stocks foul out

**By John Covaleski**

Finding "home-run" stocks and an aversion to small-capitalization stocks paid off for some special equity managers in the Pensions & Investments' Performance Evaluation Report, although most of the funds still lagged the index.

The "home run" strategy entails investing large portions of assets in a small number of stocks, which increases risk but also can substantially increase returns.

That strategy helped RepublicBank Dallas' special equity fund bring in a 75% return, leading 20 special equity funds that outperformed the Standard & Poor's 500 stock index in 1986.

The S&P returned 18.7% for the year, while the median return for the 90 special equity pooled funds of banks and insurance companies tracked by PIPER was 11.1%.

For the three years ended Dec. 31, RepublicBank again was the leader with a compound annual return of 29%. The S&P returned an annualized 18.5% for the period and the PIPER median was 10%.

The other top-performing special equity funds during 1986 were Manufacturers Hanover Trust Co.'s Supplemental Equity Fund, New York, 42.1%; Chase Manhattan Bank, New York, 31%; Security Pacific National Bank, Los Angeles, 28.6%; Trust Co. of the West, Los Angeles, 27.8%; First National Bank of Neenah, Wis., 27.1%; and National Bank of Detroit, 26.8%.

The top performers for the three years, in addition to RepublicBank, were First National Bank of Neenah, 23.8%; Citicorp's real estate stock fund, 23%; Citicorp's emerging health care fund, 22.7%; and Fidelity Management Trust, Boston, 22.1%.

Part of the reason for the poor overall performance by the special equity funds was attributed to the funds' invest in the stocks of smaller capitalization companies. Those stocks have fallen out of favor with investors.

Asked about the effect of small-cap stocks on special equity funds, Dale F. Wise, vice president and trust investment officer at Merchants National Bank of Allentown, Pa., said, "If I had to decide (on starting a new investment fund) today, it certainly wouldn't be a special equity fund."

Merchant National's fund returned 7.7% for the year.

The unpopularity of lower-cap stocks is well illustrated at Manufacturers Hanover where its supplemental equity fund, investing in intermediate-cap companies, returned 42.1% for the year and 11.2% for the quarter and its special equity fund, investing in small-cap companies, returned 10.6% and 5.6%, respectively.

But Thomas E. Larkin, managing director of Trust Co. of the West, said he believes small-cap stocks are strengthening because the buying public "is finally recognizing they're relatively cheap." He said TCW's special equity fund, which returned 27.8% for the year and 6.4% for the quarter, invests with both a small-cap and growth bias.

Other leaders in the quarter, following Manufacturers Hanover, were Society National Bank, Cleveland, whose Ohio regional equity fund returned 9.3%; Central Fidelity Bank, Richmond, Va., whose aggressive equity fund returned 8.6%; Michigan National Bank of Grand Rapids, 8.6%; and Irving Trust, New York's Special Fund II, 8.1%. The S&P returned 5.6% for the

*Continued on page 25*

## Commingled international funds

### 3-month returns

| | % |
|---|---|
| Provident Nat'l (Low p/e), Pa. | 8.9 |
| Marine Midland (Eq.), N.Y. | 8.0 |
| IDS Trust (Col. eq.), Minn. | 7.2 |
| Marsh & McLennan (Putnam) | 6.9 |
| First of Chicago (Eq.), Ill. | 6.8 |
| California First Bank (Eq.) | 6.8 |
| Morgan Guaranty (Eq.), N.Y. | 6.6 |
| First of Chicago (Non $ fixed) | 6.5 |
| Chase Manhattan (Global eq.) | 6.3 |
| Centerre Trust (W) | 6.0 |
| Bankers Trust (Eq.), N.Y. | 5.9 |
| Bessemer Trust (E), N.Y. | 5.5 |
| Bank of America (EB fixed), Calif. | 5.4 |
| RepublicBank Dallas (Stock) | 5.2 |
| Citicorp (Fixed), N.Y. | 5.0 |
| Prudential (Global bond), N.J. | 4.9 |
| **MSCI World Index** | **4.6** |
| American Nat'l, Chicago | 4.5 |
| Fidelity Mgmt. Trust (Eq.), Mass. | 4.2 |
| **MSCI EAFE Index** | **4.2** |
| Prudential (Bond), N.J. | 4.1 |
| HT Investors (Eq.), R.I. | 3.8 |
| Morgan Guaranty (Bond), N.Y. | 3.7 |
| Mellon Bank (EB eq.), Pa. | 3.3 |
| Aetna MIM (Eq.), Conn. | 3.2 |
| CIGNA Corp. (Eq.), Conn. | 2.9 |
| Citicorp (Eq.), N.Y. | 2.1 |
| Toledo Trust (Eq.), Ohio | 2.0 |
| Toledo Trust (Global bond), Ohio | 1.8 |
| Bank of America (EB eq.), Calif. | 1.6 |
| Prudential (Print eq.), N.J. | 0.6 |

### 1-year returns

| | % |
|---|---|
| Bank of America (EB eq.), Calif. | 97.7 |
| American Nat'l Chicago (Eq.), Ill. | 75.1 |
| Bessemer Trust (E), N.Y. | 75.0 |
| Marine Midland (Eq.), N.Y. | 73.9 |
| **MSCI EAFE Index** | **70.0** |
| Centerre Trust (W) | 69.4 |
| Chase Manhattan (Global eq.) | 66.2 |
| Citicorp (Eq.), N.Y. | 65.4 |
| Provident Nat'l (Low p/e), Pa. | 64.0 |
| RepublicBank Dallas (Stock) | 63.0 |
| IDS Trust (Col. eq.), Minn. | 60.9 |
| First of Chicago (Eq.), Ill. | 60.0 |
| Aetna MIM (Eq.), Conn. | 59.5 |
| Morgan Guaranty (Eq.), N.Y. | 59.4 |
| CIGNA Corp. (Eq.), Conn. | 58.2 |
| California First Bank (Eq.) | 53.7 |
| Bankers Trust (Eq.), N.Y. | 53.6 |
| Fidelity Mgmt. Trust (Eq.), Mass. | 53.2 |
| HT Investors (Eq.), R.I. | 51.8 |
| Mellon Bank (EB eq.), Pa. | 50.7 |
| Marsh & McLennan (Putnam) | 49.3 |
| **MSCI World Index** | **42.8** |
| Toledo Trust (Eq.), Ohio | 41.7 |
| Prudential (Global bond), N.J. | 38.1 |
| First of Chicago (Non $ fixed), Ill. | 35.4 |
| Prudential (Foreign bond), N.J. | 34.9 |
| Citicorp (Fixed), N.Y. | 34.8 |
| Bank of America (EB fixed), Calif. | 33.3 |
| Morgan Guaranty (Bond), N.Y. | 31.6 |
| Toledo Trust (Global bond), Ohio | 29.0 |

### 3-year returns

| | % |
|---|---|
| Bank of America (EB eq.), Calif. | 44.3 |
| **MSCI EAFE Index** | **42.2** |
| American Nat'l Chicago (Eq.), Ill. | 42.1 |
| Marine Midland (Eq.), N.Y. | 36.7 |
| Marsh & McLennan (Putnam) | 36.5 |
| First of Chicago (Eq.), Ill. | 36.0 |
| Citicorp (Eq.), N.Y. | 35.7 |
| IDS Trust (Col. eq.), Minn. | 35.4 |
| Bankers Trust (Eq.), N.Y. | 34.9 |
| Aetna MIM (Eq.), Conn. | 34.9 |
| Bessemer Trust (E), N.Y. | 34.8 |
| RepublicBank, Dallas (Stock) | 33.3 |
| Chase Manhattan (Global eq.) | 31.7 |
| Fidelity Mgmt. Trust (Eq.), Mass. | 30.5 |
| Prudential (Global bond), N.J. | 30.3 |
| Morgan Guaranty (Eq.), N.Y. | 30.3 |
| Centerre Trust (W) | 29.5 |
| **MSCI World Index** | **28.9** |
| Mellon Bank (EB eq.), Pa. | 27.3 |
| HT Investors, R.I. | 25.2 |
| Bank of America (EB fixed), Calif. | 23.8 |
| Prudential (Foreign bond), N.J. | 23.3 |
| Citicorp (Fixed), N.Y. | 22.7 |
| First of Chicago (Non $ fixed), Ill. | 22.0 |
| Morgan Guaranty (Bond), N.Y. | 20.6 |

### 5-year returns

| | % |
|---|---|
| IDS Trust (Col. eq.), Minn. | 30.8 |
| Bank of America (EB eq.), Calif. | 30.1 |
| **MSCI EAFE Index** | **28.8** |
| American Nat'l Chicago (Eq.), Ill. | 27.7 |
| Marsh & McLennan (Putnam) | 27.4 |
| Bankers Trust (Eq.), N.Y. | 26.7 |
| Citicorp (Eq.), N.Y. | 26.1 |
| First of Chicago (Eq.), Ill. | 25.5 |
| Centerre Trust (W) | 24.8 |
| Morgan Guaranty (Eq.), N.Y. | 24.6 |
| **MSCI World Index** | **24.0** |
| Bessemer Trust (E), N.Y. | 23.5 |
| Mellon Bank (EB eq.), Pa. | 22.0 |
| Chase Manhattan (Global eq.) | 20.7 |
| Bank of America (EB fixed), Calif. | 16.9 |
| First of Chicago (Non $ fixed), Ill. | 16.4 |
| Morgan Guaranty (Bond), N.Y. | 16.0 |
| Citicorp (Fixed), N.Y. | 15.0 |

### 10-year returns

| | % |
|---|---|
| **MSCI EAFE Index** | **22.2** |
| Morgan Guaranty (Eq.), N.Y. | 19.5 |
| First of Chicago (Eq.), Ill. | 19.0 |
| **MSCI World Index** | **17.3** |

# Sector . . .

*Continued from page 23*

We're leery of the profit outlook in more mature (European) economies," Ms. Abitanta said.

In early 1986, the firm had a 23% exposure to Japan, which had increased to 50% by June. Bessemer cut back to 39% in the fourth quarter.

"We still think Japanese protectionist pressures will result in further appreciation of the yen," she said, explaining why the firm continues to overweight domestic sectors like construction, retail, and health care sectors.

Marine Midland Bank's fund was successful because Wardley, the fund's manager, was accurate in its strong country plays.

"In 1986, the environment in Europe was a market selection environment vs. 1985 when all markets did well in Europe," said Deborah George, senior vice president at Wardley.

"Japan this year was very much a sector selection game," she added. "We were in exactly the right sectors — domestic consumer-oriented sectors. Those are the stocks that moved because individuals continued to pour money into those areas of the market."

The fund began 1986 heavily weighted in Europe. At the end of the year, European exposure had been pared to 50% with the remaining 50% in the Pacific Basin, Ms. George said.

Bullish on the United Kingdom, Wardley hopes to increase its exposure there to 24% by year end. In September, its U.K. holdings were 13%.

But it has reduced its exposure to the Spanish market to 4% from last year's 5% and its holdings in France to 8% from 11%. The fund has left the German and Italian markets, after having 11% and 9% in those markets, respectively.

It started 1986 with 26% invested in Japan, and ended with 39%. The firm's other Pacific Basin holdings include 5% in Australia, 4% in Singapore and 5% to 6% in Hong Kong.

IDS International, which manages $500 million for U.S. tax-exempt clients, has positioned itself to avoid countries damaged by strong local currencies. However, in the fourth quarter, it increased its exposure to Japan relative to other portfolio managers.

"At the moment we have 41% in Japan," said Mark Hayes, vice president and senior portfolio manager.

Like Wardley, IDS sees continued heavy domestic cash flow into the Japanese market, despite valuation problems perceived by other managers.

IDS also boosted its exposure to Hong Kong, Australia and Singapore in the fourth quarter. The assets came in part from German investments. IDS cut its weighting there to 6% to 7% from the fourth quarter's 17% to 18%.

"We wanted to get out of traditionally strong currency blocks — those parts which are export-oriented. In Germany, domestic

*Continued on page 25*

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# Strategy scores . . .

*Continued from page 23*

period and the median was 3.1%.

Ben Fischer, vice president and manager of the corporate asset management group at RepublicBank, attributes home-run thinking to much of the select equity fund's success.

"You could say we're swinging for the fences. To get a 75% return, you need a few home runs and we got the home runs," he said.

"Sure, you're at risk, but if you consistently pick stocks with the best characteristics, you'll end up doing better."

The fund managers follow a value investing approach and look primarily for low price-to-earnings ratios and high dividend yields.

Among the fund's 1986 home runs was **Galoob Lewis Toys Inc.**, which it acquired in late 1985 for 6⅝ and sold off in September at 16 (the buy and sell figures are adjusted for a 3-for-2 split that occurred while the stock was held). By the time it was sold, Galoob represented 22% of the fund's portfolio.

**Alaska Air Group Inc.** was another home run stock for RepublicBank. It invested 17% of its total assets in the stock when it bought at 16 and within four months sold it at 21.

Another home-run-hitting fund is National Bank of Detroit's Intrinsic Value Fund, which has $38 million in assets and limits itself to 40 stock choices.

"We don't want to dilute our successes with a lot of names," said Peter Zuger, vice president of special funds.

Part of the fund's approach is looking for companies that are undervalued because of "transitory problems," such as an operations difficulty that is in the process of being repaired, said Mr. Zuger.

For example, the fund acquired **Goodyear Tire & Rubber Co.** stock in early 1986 when it was selling in the low 30s. Investors then were concerned about problems with an oil pipeline the company was building between California and Texas. After the pipeline problems were repaired, the fund sold the stock in the high 40s, he said.

Also helping to drive up the price of Goodyear stock was a takeover attempt by a group led by Sir James Goldsmith.

But the home-run strategy can backfire, as it did for Merchants National in Allentown, which holds no more than 10 different stock names in its $1.2 million special equity fund.

Mr. Wise said among the largest losses was **Ryan Beck & Co.** The fund placed 8% of its assets in Ryan Beck when the stock was selling at 13, and then watched it drop to 8 by year's end.

The stock since has climbed back to 10.

Merchants National did have some winners, Mr. Wise noted. Among them was **Caremark**, a health services company that it bought around 12 and sold around 26.

Jeff Mills, senior vice president at Manufacturers Hanover and investor for its supplemental equity fund, which returned 42.1% in 1986, said the fund invests in stocks that are undervalued because the companies are undergoing corporate restructuring. He called them "story stocks."

Among its 1986 stock purchases was **Mead Corp.**, which was purchased at 35 but has recently climbed to 60; **Louisiana-Pacific Corp.**, which was purchased at 22 and since has climbed to 40, and **Weis Technologies**, which was bought at less than 12 and since has reached 22.

The supplemental fund, which has assets of $95 million, holds no more than 25 to 30 stocks, Mr. Mills said.

American Fletcher National Bank, Cleveland, whose Natural Resources Fund places heavy emphasis on high-yield stocks such as utilities, and Citicorp's Real Estate Stock Fund, which invests in the stocks of real estate related companies, also did well last year.

The American Fletcher fund returned 25.8% in 1986 and a compound annual 18.8% for the three years. The Citicorp fund returned 25.6% and an annualized 23% for the respective periods.

Fran Brazette, vice president/investment officer at American Fletcher, said much of the investment interest in high-yield stocks has come from investors who have pulled their money out of the bond market because of low interest rates.

Kenneth D. Statz, a vice president with Citicorp, said the real estate fund's advantage over traditional real estate investments is its liquidity. "We're not stuck in any one place, we can move to the hot markets, and someone's always making money in real estate," he said.

Mr. Statz said the pension funds investing in the $30 million fund consider investments there as part of their real estate allocations.

The fund invests in development companies, such as **Rouse Co.**, builders such as **Toll Brothers Inc.** and real estate investment trusts. Its REIT investments include **First Union Real Estate Investments, Pennsylvania**

*Continued on page 26*

# International . . .

*Continued from page 24*

sectors are not well represented in the market. You can't get money into some sectors."

Noting the effect of the strong yen, Mr. Hayes said, "We're out of export and into domestic (industries) where the real profits will be made" in Japan.

He likes services such as financials, as well as housing and construction stocks since the government is encouraging those two industries.

"Forty percent of corporate profits in the Japanese stock market will be in the financial sector in 1987," said Mr. Hayes.

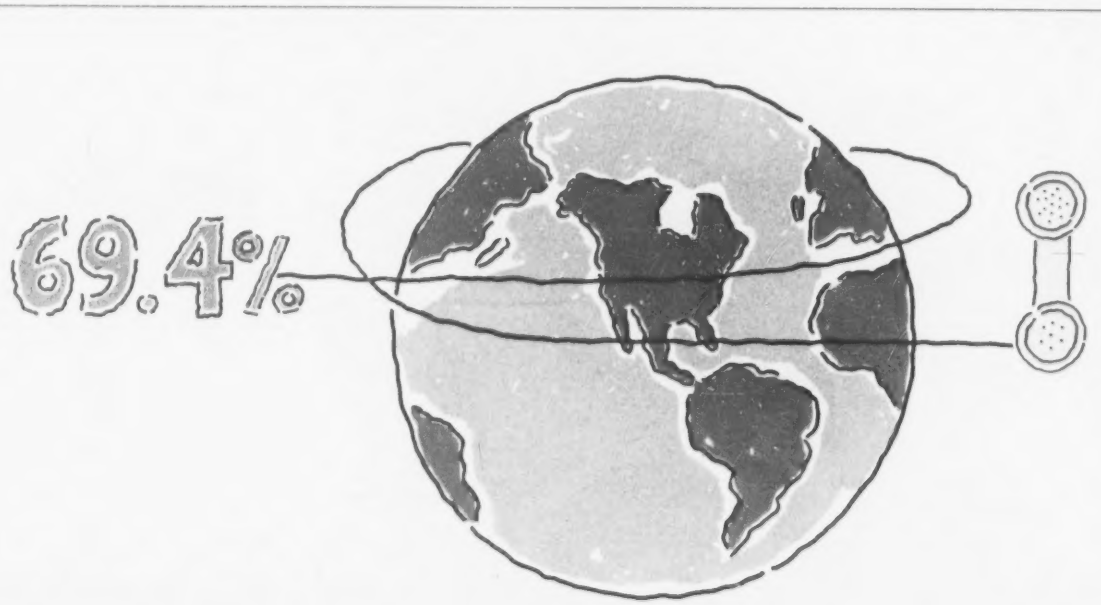
Provident Capital Management, which manages Provident National's $27 million low p/e fund, purchases data bases and computer screens to calculate median p/es for various markets. The p/e cutoff for a stock pick by the firm differs by country.

Provident's 8.9% leading fourth quarter performance marked a relative improvement over its respectable but sub-index one-year return of 64%.

"In Japan, (in 1986) the best performing sectors were large-capitalization sectors; p/e was not a criterion on whether a stock performed well or not," said Sandor Cseh, vice president-international investments.

"Over time, low p/e works but it doesn't work every year. In 1987, we're not likely to see that 1986 trend continue. On the other hand, you're not going to see a quick shift. The difference in p/e between small- and medium-cap stocks is not that big. You'll see good value in middle-cap stocks."

He expects good value in Japan this year, particularly for stocks with low p/es, good fundamentals and capitalizations of more than $1 billion. The firm will keep a minimum of 40% in Japan. It also has 5.75% — 2.5 times the EAFE index's weighting of 2.3% — in the Netherlands. ■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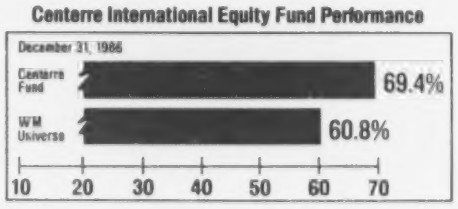


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# Strategy . . .

*Continued from page 25*

**Real Estate Investment Trust and Western Investment Real Estate Trust.**

Citicorp's real estate fund also placed second in the five years ended Dec. 31, returning an annualized 27.9%.

Others in the top five were Security Pacific National Bank's Growth Fund G, with 29.9%; Chase Manhattan's intermediate-cap fund, 24%; Wachovia Bank, Winston-Salem, N.C., 23.3%; and Provident National Bank, Philadelphia, 23.1%. The S&P returned 19.9% and the median was 16.4%.

For the 10 years, the leaders were MTrust, Dallas, with a compound annual 24.1%; California First Bank, San Diego, 23.9%; Equitable Bank, Baltimore, 23.6%; and Bankers Trust Co., New York, 22.5%. The S&P was 13.9%, and the median was 17.2%. ■

## Top quartile commingled special equity funds

### 3-month returns

| | % |
|---|---|
| Manufacturers Hanover (Supp.) | 11.2 |
| Society Nat'l (Ohio reg.) | 9.3 |
| Central Fidelity (EB Agg.), Va. | 9.1 |
| Mich. Nat'l of Gr. Rapids (Agg.) | 8.6 |
| Irving Trust (II), N.Y. | 8.1 |
| Marsh & McLennan (Putnam) | 8.0 |
| RepublicBank Dallas (Select) | 7.4 |
| First of Boston (Yield), Mass. | 6.9 |
| Old Second Nat'l (HR 10), Ill. | 6.7 |
| Nat'l City Cleveland (R.E.) | 6.6 |
| Connecticut Nat'l (Supp.) | 6.5 |
| Trust Co. of the West | 6.4 |
| Northern Trust, Ill. | 6.4 |
| First of Boston (II), Mass. | 6.2 |
| First of Alabama, (Spec. CTF) | 6.1 |
| First Pennsylvania Bank | 6.0 |
| First Nat'l of Tulsa (S'west) | 5.7 |
| CIGNA Corp (Em. gr.), Conn. | 5.6 |
| Manufacturers Hanover, N.Y. | 5.6 |
| **Standard & Poor's 500** | **5.6** |
| Manufacturers Hanover (Uncom.) | 5.6 |
| Comerica Bank, Mich. | 5.6 |
| California First Bank (Supp.) | 5.5 |
| Security Pacific (G), Calif. | 5.4 |

### 1-year returns

| | % |
|---|---|
| RepublicBank Dallas | 75.0 |
| Manufacturers Hanover (Supp.) | 42.1 |
| Chase Manhattan (Inter. cap) | 31.0 |
| Security Pacific (G), Calif. | 28.6 |
| Trust Co. of the West | 27.8 |
| First of Neenah, Wis. | 27.1 |
| Nat'l Bank of Detroit (F) | 26.8 |
| American Fletcher (E) | 25.8 |
| Citicorp (R.E), N.Y. | 25.6 |
| Society Nat'l (Earn. mom.) | 24.5 |
| Society Nat'l (Ohio reg.) | 24.1 |
| Manufacturers Hanover (Uncom.) | 23.2 |
| Northern Trust, Ill. | 22.9 |
| Harris Trust (Spec. Cap.), Ill. | 22.4 |
| Fidelity Mgmt. Trust (Agg.) | 22.3 |
| First of Boston (Yield) | 21.9 |
| Phoenix Mutual (S), Conn. | 21.5 |
| Central Fidelity (EB Agg.), Va. | 20.7 |
| Marsh & McLennan (Putnam) | 19.7 |
| First of Neenah (Reg. bank) | 19.6 |
| Old Second Nat'l (HR 10), Ill. | 19.5 |
| **Standard & Poor's 500** | **18.7** |
| Mellon Bank (EB), Pa. | 17.8 |
| Wachovia Bank (Div.), N.C. | 16.5 |

### 3-year returns

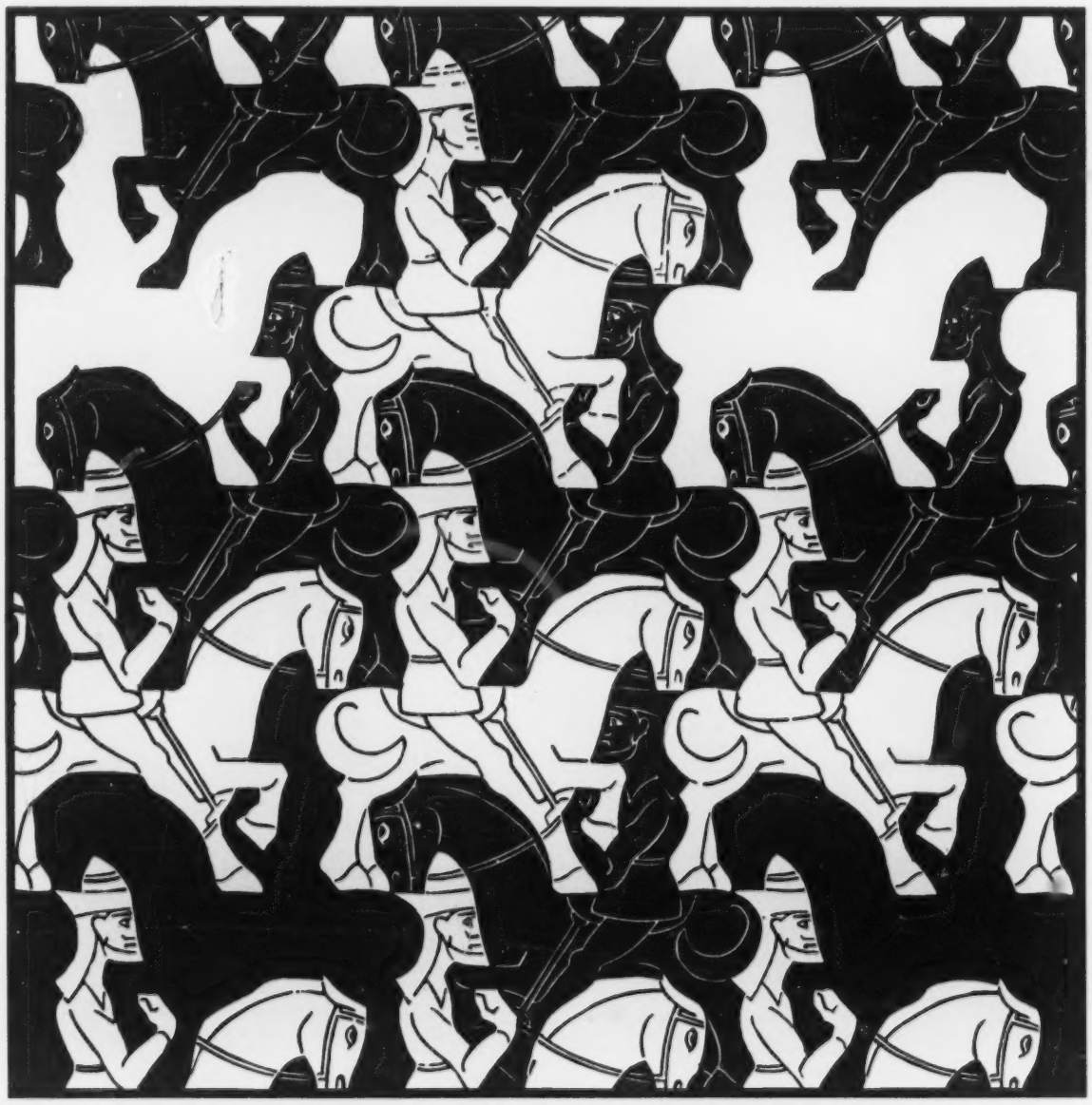
| | % |
|---|---|
| RepublicBank (Select), Dallas | 29.0 |
| First of Neenah (Inc.), Wis. | 23.8 |
| Citicorp (R.E.), N.Y. | 23.0 |
| Citicorp (Emerg. health), N.Y. | 22.7 |
| Fidelity Mgmt. Trust (Agg.), Mass. | 22.1 |
| Chase Manhattan (Int. cap.), N.Y. | 21.8 |
| Manufacturers Hanover (Supp.) | 20.6 |
| Trust Co. of the West | 20.4 |
| First of Boston (Yield), Mass. | 19.9 |
| Mich. Nat'l of Gr. Rapids (Agg.) | 19.4 |
| American Fletcher (E), Ind. | 18.8 |
| **Standard & Poor's 500** | **18.5** |
| Old Second Nat'l (HR 10), Ill. | 17.4 |
| Manufacturers Hanover (Uncom.) | 17.1 |
| Citicorp (Spec. sit.), N.Y. | 16.8 |
| Mellon Bank (EB), Pa. | 16.4 |
| Associated Kellogg (EB gr. stk.) | 16.2 |
| Society Nat'l (Ohio reg.) | 16.1 |
| LaSalle Nat'l (Small cap.), Ill. | 16.0 |
| First of Minneapolis (20) | 15.9 |
| Shawmut Bank (Target), Mass. | 14.7 |
| MBank Austin (Keogh), Texas | 14.7 |

### 5-year returns

| | % |
|---|---|
| Security Pacific (G), Calif. | 29.9 |
| Citicorp, (R.E.), N.Y. | 27.9 |
| Chase Manhattan (Int. cap.) | 24.0 |
| Wachovia Bank (Div. spec. val.) | 23.3 |
| Provident Nat'l, Pa. | 23.1 |
| First of Boston (Yield), Mass. | 22.5 |
| Society Nat'l (Ohio reg.) | 22.3 |
| Citicorp (Spec. sit.), N.Y. | 21.8 |
| Connecticut Nat'l Bank (Supp.) | 21.6 |
| Manufacturers Hanover (Uncom.) | 21.5 |
| Nat'l Bank of Detroit (Oppor.) | 20.6 |
| Chase Manhattan (Value), N.Y. | 20.2 |
| First Trust Co., Minn. | 19.9 |
| **Standard & Poor's 500** | **19.9** |
| First of Maryland | 19.7 |
| Bankers Trust (Supp.), N.Y. | 19.5 |
| Manufacturers Hanover (Supp.) | 19.2 |

### 10-year returns

| | % |
|---|---|
| MTrust (Growth), Texas | 24.1 |
| California First Bank (Supp.) | 23.9 |
| Equitable Bank, Md. | 23.6 |
| Bankers Trust, (Supp.), N.Y. | 22.5 |
| Northern Central, Pa. | 22.5 |
| First of Maryland | 21.4 |
| Chase Manhattan, N.Y. | 20.5 |
| Bank of America | 19.7 |
| Manufacturers Hanover (Supp.) | 19.6 |
| Associated Kellogg (EB Gr. stk.) | 19.4 |
| Connecticut Bank & Trust | 19.4 |
| **Standard & Poor's 500** | **13.9** |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# *Medians lag the indexes*

WAYNE, Pa. — The median stock and bond funds in the SEI universe traded blows with industry benchmarks for the quarter and the year ended Dec. 31, and usually came up short, according to a report by SEI Funds Evaluation Services.

The median return for the equity fund for the quarter was 4.3%, compared with the Standard & Poor's stock index return of 5.6%.

The median fund for the 12-month period also lagged the S&P, returning 16.7% vs. 18.7% for the index.

For longer periods, the median fund also got clobbered by the index, returning compound annualized returns of 15.9% and 18.1% for the three- and five-year periods, respectively. The S&P 500, for the same periods, returned an annualized 18.5% and 19.9%, respectively.

The equity fund universe represents 943 pension fund accounts holding a market value of $110.2 billion in assets. The bond fund universe represents 426 funds holding a market value of $46.2 billion. The balanced universe is comprised of 844 funds and has a market value of $96.7 billion.

Although the return of the median bond fund topped the indexes for the quarter, for longer periods the indexes won out again.

The median return for the quarter was 3.4%, vs. 3.3% for the Salomon Brothers Broad Investment Grade Bond Index and 3.1% for the Shearson Lehman Government/Corporate index.

For the year, the median fund returned 14.7% vs. Salomon BIG's 15.5% and Shearson Lehman's 15.6%.

For the three- and five-year periods, the median bond fund in SEI's universe returned compound annualized returns of 16% and 17.5%, respectively, vs. Salomon's annualized 17.5% and 18.2% and Shearson Lehman's 17.3% and 17.9%.

The median return for the equities-only portion of the SEI balanced fund was 5.2% for the quarter and 18.1% for the 12 months.

The median for the bonds-only portion of the balanced fund was 3.4% for the quarter and 14.9% for the year.

The total SEI balanced fund returned 4.2% and 15.6% for the quarter and one-year period. ■

# International

# Settlement problems tax funds

## Investors' opportunity and dollar costs, performance can suffer

By Marlene Givant

A number of institutions stopped investing in Italian stocks — missing last year's 65.6% rise in that market — because of problems in settling trades there. And pension fund executives are voicing similar settlement complaints about Spain, France, Switzerland and Japan.

Settlement problems not only can cut into opportunity costs, but also into actual dollar costs and investment performance.

Liquidating holdings in some markets is easier said than done.

Because settling trades in Italy can take as long as 12 months, the approximately $600 million Retirement System for Savings Institutions, New York; an unidentified international money manager of the $9 billion GTE Corp., Stamford, Conn., pension plan; SBC Portfolio Management International Inc., New York; and James Capel & Co., a London investment firm, have stopped investing there.

John Conlin, SBC's marketing director added, "Spain's market is like a Roach Motel — you check in but you don't check out.

"In international investing you have to know your market, know your returns will offset a market's (settlement) costs. You've got to plan entrances and exits."

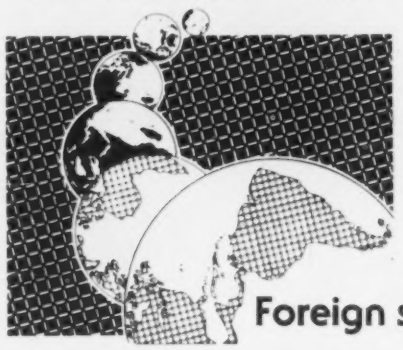
Fast settlement also can be a problem. The $6 billion internally managed Tennessee Consolidated Retirement System, Nashville, and the $52.3 billion Teachers Insurance and Annuity Association — College Retirement Equities Fund, New York, noted Japan's three-day settlement period is hard to handle.

The U.S. market's settlement period is five days.

The internally managed $1.1 billion Young Men's Christian Association Retirement Fund, New York, has had problems clearing some Swiss stocks and has experienced delays of about two weeks on the Continent in general.

A trade is settled when a custodian has paid a broker for securities bought or when a custodian delivers securities that have been sold and receives the proceeds of the sale. Clearing is the final exchange of securities for cash on delivery.

A failure of either party to receive or



Foreign securities

deliver securities by the effective settlement date is called a fail. Fails are common in international trades because for the most part, securities must be delivered physically. In the United States, trades are settled through the Depository Trust Co., a central automated clearing system.

The physical delivery leaves ample room for human error. "When there's a small error in a stock certificate, you can't pencil it out; it has to be reprocessed," noted one international broker.

A security does not reach a custodian until it has been registered in a pension fund's name. Because of the time involved in some countries, if a manager or fund decides to sell that security in the interim, the custodian can receive instructions to deliver shares that have not yet been delivered.

To combat settlement problems, the $6.6 billion United Nations Joint Staff Pension Fund, New York, makes sure it approves of — and keeps in touch with — the 20 local subcustodial banks chosen by its global custodian, Fiduciary Trust Co. of New York.

TIAA-CREF also regularly contacts its overseas subcustodians. In addition, it has adopted standardized numbers for stocks to avoid mix-ups in listing names of foreign securities.

Wardley Investment Services International, New York, has speeded settlement by holding stocks through its own settlement department instead of a custodial bank.

Among problems contributing to settlement woes is the overtaxing of foreign stock exchanges because of the explosion in global investment. U.S. investors usually trade securities frequently, while Europeans traditionally have bought and held securities.

Further muddling international settlement are differences in time zones, exchange rates, markets and regulations. Language differences complicate the communication of orders and exchange of information.

And with generally higher trading costs in overseas investing, settlement mix-ups can be more expensive to the broker, custodial bank or investment manager paying for a fail.

Differences in settlement periods among markets can cut into investment performance.

Often managers must keep cash reserves to cover trades even though they might want to remain fully invested. Large international managers often keep pools of cash in different countries for that purpose.

"Performance drops off when you can't get the money back from the stock you've sold in order to buy another. We are in such a competitive marketplace that to lose 50 to 60 basis points (by holding cash required for trades) could cost a manager an appointment. Settlement is the biggest problem facing international managers. What we have now is growing pains of an industry," said Mr. Conlin of SBC.

The investors who froze investments in or dropped out of the Italian market had varying explanations, with one underlying reason.

Late in 1985 the Retirement System for Savings Institutions, advised its international managers to hold Italian stocks they had but not to purchase any more securities in Italy.

"We're still taking that position," said Bill Dannecker, president and chief operating officer. "As I understood it, the Italian custodial bank, (Banco Commerciale d'Italia, Milan), was not able to track the securities we had. The securities hadn't been entered; we weren't able to confirm to our auditors that the securities were there."

The verification for transactions in late 1985 came only two months ago. "That leads us to believe the problem is not yet corrected," he said.

"I'm sure our international managers would have invested more in the Italian market, but we haven't tracked that closely the Italian market vs. others we were in. We don't know whether we gained or lost by that move but our man-

*Continued on page 41*

# Index managers get biggest slice

By Marlene Givant

As a large number of corporate and public funds plunged for the first time into overseas investing last year, two leading index fund managers reeled in about 30% of the roughly $4.9 billion in new international equity business in 1986, according to *Pensions & Investment Age*.

The top gainer, State Street Bank and Trust Co., Boston, added $1.12 billion in new business for the 11 months, ended Dec. 1, that were covered by the survey.

Wells Fargo Investment Advisors, San Francisco, another leading index player, ranked fourth with $310 million in new business for the period.

Even among active managers, a small number gained the bulk of the new business.

Warburg Investment Management International, London, and Schroder Capital Management International, New York, ranked second and third behind State Street in new international equity business, reporting $421 million and $407 million, respectively.

New business includes contributions from new U.S. tax-exempt clients and additional contributions from existing U.S. tax-exempt clients.

Other international equity managers ranked among the top 10 were: ABD International Management Corp., New York, $215 million; American Express Asset Management, London, $212 million; Arnhold & S. Bleichroeder International, New York, $210 million; Capital Guardian Trust Co., Los Angeles, $179 million; The Prudential Asset Management Group, Newark, N.J., $140 million; and IDS International Inc., Minneapolis, $118.5 million.

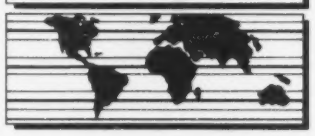
With its gain, State Street nearly doubled its tax-exempt assets under management. And as of Dec. 31, the firm had $3.3 billion in tax-exempt assets from U.S. and non-U.S. tax-exempt clients, according to Harry Sterling, vice president and director of marketing.

The firm, which began offering a Morgan Stanley Capital International Europe Australia Far East index fund in 1978, its first overseas index fund, has developed a base of 45 clients. A large number of new clients last year were public funds, he said.

"When interest in international indexing slackened off in the early 1980s, some firms dropped out," while State Street remained,

*Continued on page 38*

**International update**



## Global markets rise

NEW YORK — The dollar's January tumble boosted returns for dollar-denominated investors in Japan and offset the decline in West Germany's stock market.

With the global economy's slow steady growth, low and falling interest rates and excess liquidity, the World Index rose 11.6% and the Europe Australia Far East index grew 10.5% in January, according to the Morgan Stanley Capital International Perspective, which publishes the indexes.

Nine of the 19 national markets comprising the World Index soared to new highs during January. In local currency terms, Denmark rose 14.4%. Also, Mexico surged 25.4%, reversing its 1986 last place standing.

Other hefty returns were 13% for the United States; Japan, 11.8%; Spain, 10.9%; and Canada, 10.6%. The United Kingdom and Singapore/Malaysia indexes moved up 8.7% and 8.9%, respectively.

In local currency terms, stock markets dropped in Austria and Sweden by 11.2% and 12.5%, respectively.

The fall of the dollar against such currencies as the yen provided significant gains for dollar-denominated investors. In dollar terms, the Japanese market rose 16%, the Canadian market rose 13.9% and the Mexican and Danish markets rose 17.1% and 21.1%, respectively.

## Acquisition complete

LONDON — The newly formed Wardley Investment Services International Ltd. has acquired all the business of Wardley Marine International Investment Management, London.

Formerly a 50-50 partnership of Wardley Investment Services Ltd., Hong Kong, the acquiring firm's parent company, and Marine Midland Banks Inc., New York, Wardley Investment Services International will continue as investment adviser to the Marine Midland International Equity Fund, New York.

"The acquisition of the business provides us with a stronger foothold in the Western Hemisphere," said Thomas A. Veitch, the firm's managing director.

With the new arrangement, Wardley Investment Services International will manage $345 million for tax-exempt clients, including $315 million for non-U.S. tax-exempt clients and the $30 million in the Marine Midland fund.

The price of the acquisition was not disclosed.

*Continued on page 38*

# Get slice . . .

*Continued from page 37*

Mr. Sterling said.

"The product we've been providing is an international index fund primarily. When people are thinking about investing in an international index fund, they come to State Street. We have good people running it and good people marketing it."

The firm did not disclose the names of new clients for publication.

Second-ranked Warburg, which manages more than $915 million for tax-exempt clients, attributes its growth to top-quartile performance.

"I think from our point of view growth has reflected performance over the last few years," said John G. Townsend, director. "We're right at the top of the pack" vs. other money managers in the Wood Mackenzie Co. Inc., New York, universe for one-, three- and five-year periods.

"If you race around the country enough and knock on doors enough and you've got good (performance) numbers, you get new business," said Mr. Townsend.

The firm began the year with one person reporting to clients; it now has four reporting staff members. It also added seven portfolio managers, bringing the total management staff to 35.

**Most new international equity business**

| Company | $ mils. |
|---|---|
| State Street Bank, Boston | 1,120 |
| Warburg Invest. Mgmt., London | 421 |
| Schroder Capital Mgmt., New York | 407 |
| Wells Fargo Invest., San Francisco | 310 |
| ABD Mgmt., New York | 215 |
| American Express Asset Mgmt., New York | 212 |
| Arnhold and S. Bleichroeder, New York | 210 |
| Capital Guardian Trust, Los Angeles | 179 |
| Prudential Asset Mgmt. Group, Newark, N.J. | 140 |
| IDS, Minneapolis | 118.5 |

"We've been preparing for growth. We've seen our competitors grow and then have clients not be able to ring them up . . . a huge education job needs to be done — that's right and proper."

Keeping clients in the dark as to world market conditions and firm strategy can be dangerous.

"If you have a bad quarter, you don't have a leg to stand on . . . We let clients know what we're doing and why. We tell them what's going right and wrong."

Not much has gone wrong so far. The firm's composite international equity returns were 65.9% for the year, a compound annualized 37.1% for three years and an annualized 27.1% for the five years ended Dec. 31.

This compares with the EAFE index returns of 70% for one year, an annualized 42.2% for three years and an annualized 28.8% for five years.

Warburg's new clients include San Bernardino County Employees' Retirement Association, San Bernardino, Calif.; Massachusetts Pension Reserves Investment Trust, Boston; Dun & Bradstreet Corp., New York; and the Arizona State Retirement System, Phoenix.

Schroder, the third-ranked manager, added 12 new clients during the 11-month period.

Among them are PaineWebber Inc. pension plan, New York; Northeast Utilities Service Co., Hartford, Conn.; Houston Police Officers' Retirement System; and State of Hawaii Employees' Retirement System, Honolulu.

"We did so well last year because of consistency of personnel and good performance," said Sharon L. Haugh, first vice president.

The firm, which managed $1.7 billion in tax-exempt assets as of Dec. 31, had returns of 60.7% for the year, 35.9% for the three years and 29.1% for the five years ended the same date.

Wells Fargo, like State Street, benefited from indexing's surge in popularity last year.

"We're one of the leading indexers in the business. In 1986, there was lots of interest in indexing in general. People interested in international are also interested in indexing. We seem to be one of the logical choices," said Bob Haber, vice president.

Most of the new business was corporate accounts going international for the first time. "Indexing is a fairly inexpensive way of getting into that market," he said.

Two of the eight new clients gained last year were public funds, and the number is expected to increase in 1987. The public funds added were Baltimore County Employees' Retirement System and the Prince Georges County, Maryland, employee benefit fund. ■


# An International Quiz

## Do you use an international investment manager who...

- ☑ Ranks in the top decile of INTERNATIONAL EQUITY managers and has beaten EAFE by 5% a year.
- ☑ Ranks #1 in GLOBAL BONDS over the past 1, 2 and 3 years and has beaten the world bond index by 9% a year.
- ☑ Offers a GLOBAL CASH MANAGEMENT vehicle yielding over 13% a year.

## Want One?

PCM INTERNATIONAL

**Contact:** Barry Gillman, Managing Director, (201) 877-7982, or Buck Bowen, Prudential Asset Management Company, (201) 877-9298. PCM International is an affiliate of the Prudential Insurance Company of America.

**Cash Management:** PruTrust GLOBAL YIELD portfolio gross yield 13.3% as of February 1987.

**Indices:** Salomon Bros. World Bond Index, Morgan Stanley Capital International Europe, Australia and Far East Index.

**Universes:** Frank Russell World Bonds–PruTrust GLOBAL BOND FUND, 1984-86; InterSec Non-US Equities–PCM's PRINT portfolio, 1985-86.


## International . . .

*Continued from page 37*

Wardley Marine International Investment Management managed $155 million in total tax-exempt assets at the time it was acquired.

### *Stock buys healthy*

NEW YORK — Despite the fact U.S. investors sold a net $800 million in foreign stocks in the third quarter of 1986, the first three quarters' net purchases were a healthy $3.4 billion, according to a report by the Securities Industry Association.

Record net purchases of $4.2 billion in foreign stocks by mid-1986 were offset by the third quarter net sales, many of which were of Japanese stocks.

In the same period, gross activity hit $72.4 billion, 59% higher than 1985's annual record of $45.6 billion.

During 1986, U.S. investors had a love-hate affair with Japanese stocks. They followed their first quarter net purchases of $1.1 billion with net purchases of only $198 million in the second quarter and swung to net sales of $1.2 billion in the third quarter.

After a hefty gain of more than 20% in the first quarter, the Japanese stock market slowed in the second quarter. Although upward momentum resumed in the third quarter, the Japanese market was particularly turbulent in September.

Some of the third quarter's climb was prompted by expectations of interest rate cuts. When a reduction in Japanese rates did not follow a decrease in U.S. rates, the Japanese stock market sold off sharply, the report said.

U.S. investors took a cautious approach to European stocks in the third quarter. Net purchases plunged to $202 million from $1.3 billion in the second quarter.

Underlying the drop was a 92.6% cutback in net purchases of U.K. stocks to $55 million in the third quarter from $746 million in

*Continued on page 40*

# Corporate Finance

## Leasing OK in spite of tax reform

**By Brad Rudin**

Predictions of tough times for the leasing industry in the aftermath of tax reform now appear overstated.

Reduced tax rates, longer depreciable lives and the end of the investment tax credit were expected to stunt the industry, which, according to government figures, had grown almost 19% between 1978 and 1984.

Lessors have emerged as major players in the equipment financing business despite legislative changes that have reduced the benefits of tax-oriented deals, said Mark S. Comora, president of Commercial Union Capital Corp., New York.

"Even though leasing may not make sense in as many places as before, leasing as a form of financing is so widely accepted that every good idea gets a very fair hearing."

Leasing in recent years has financed more capital investment than equity and debt offerings combined, according to figures compiled by the U.S. Department of Commerce and the American Association of Equipment Lessors, a trade group based in Arlington, Va.

Tax advantages will play a smaller role as lessors diversify into real estate leases, secured loans and operating leases, according to the Commerce Department's report.

*Continued on page 48*

# Mack rolls out $450 million TRUCS

**By Marci Baker**

ALLENTOWN, Pa. — Mack Trucks Inc. is revving up to launch the first public offering of securities backed by heavy duty truck receivables, saving in excess of 200 basis points on its cost of debt.

Mack Trucks Receivables Corp. filed a shelf registration with the Securities and Exchange Commission in late February to issue $450 million of asset-backed notes. The company is a special purpose subsidiary of Mack Financial Corp., which, in turn, is a subsidiary of Mack Truck.

Mack's first offering likely will be about $250 million and is expected to hit the market in late March, said Joseph McDevitt, treasurer of Mack Financial and Mack Trucks Receivables.

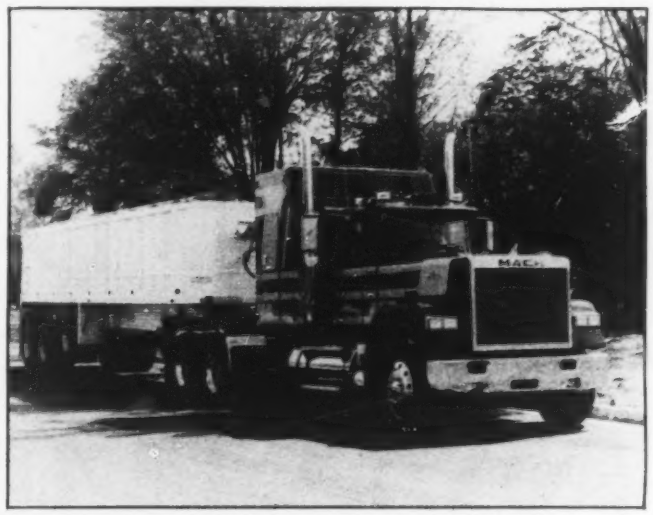
Like previous asset-backed deals, such as CARs, automobile receivables, and CARDs, securities backed by credit card receivables, Mack's will carry its own signature: TRUCS, or truck receivables underlying certificates.

The deal, which Shearson Lehman Brothers Inc., New York, and Mack have worked on since last summer, will be Shearson's first major public receivables transaction. Mack Truck Receivables will use the proceeds to buy the heavy duty truck loans from Mack Financial, which, in turn, will use the money to pay down debt. "We should significantly reduce our cost of debt with the issue," Mr. McDevitt said.

The company now carries about $360 million in intermediate and long-term debt on its books, with an average interest rate of 10.2%. "We were quite happy with that rate for a long time, but now it's over current market rates," he said.

Unlike most other receivables transactions, which typically are structured as pass-through certificates, the Mack Truck offering will be structured as secured debt via a pay-through format.

Pass-through instruments represent interests in the underlying collateral, with principal and interest of that collateral being passed through to holders of the certificates.



*Mack Trucks, Inc., manufacturer of this Super-Liner II, filed a shelf registration to issue $450 million of receivable-backed securities, a first for the trucking industry.*

Under the TRUCS structure, Mack Financial will sell the heavy duty truck receivables to that subsidiary, which, in turn will issue debt against them.

One advantage of that structure is it eliminates the prepayment uncertainty surrounding the underlying receivables, said Thomas Richardson, senior vice president at Shearson.

Early prepayment risk imposes an element of uncertainty on the cash flows and final maturity with the pass-through structure. With the secured debt structure, investors will get an instrument with a known stream of payments and a known final maturity.

"One reason we've taken the approach is because there's not much familiarity with the performance characteristics of prepayments on heavy duty trucks," Mr. Richardson said. By eliminating prepayment uncertainty, Shearson expects to gain better pricing on the deal.

The loans backing the TRUCS deal will be fixed-rate, fixed-term retail loans of Mack Financial. Prepayment rates on heavy duty truck financings tend to be low. "In the last rapid rate decline, there wasn't any dramatic change in the performance of prepayments," noted Mr. Richardson.

The lower prepayment rates are mainly because of the nature of truck financing and the life of the vehicle.

Heavy duty truck loans generally are made to operators of one- to five-truck fleets. The terms of the financings generally carry five-year lives and rapid payment streams, while Mack trucks are on the road for an average of 10 to 12 years. By the time an operator may think it worthwhile to refinance, he's paid off much of the original loan and is building up equity in the truck.

If the market responds well to the initial TRUCS transaction, Mack Truck plans to do at least two more deals of $100 million each.

A letter of credit from a highly rated bank will likely provide additional credit enhancement for the TRUCS transaction. Whether the deal will require overcollateralization will be a function of negotiations with the bank providing the letter of credit.

The transaction will be treated as an intercompany sale of assets. The receivables will continue to show up on Mack Truck's consolidated balance sheet. The equity or residuals associated with the deal will continue to be owned by Mack Financial. ■

## New issues of corporate securities

Feb. 2 — Feb. 13

| Issue date | Company | Amount ($ mil.) | Type of security | Offering price Debt (%) Share ($) | Gross spread as % offer price | Where traded (to list) | Managers |
|---|---|---|---|---|---|---|---|
| **Debt** | | | | | | | |
| 2/5 | Enron Corp. | 625.00 | Sr. Sub. Deb. | 85.91% | 2.751 | OTC | Drexel Burnham Lambert |
| 2/4 | FBC Mortgage Securities Trust XI | 495.00 | GNMA CMO | 99.88% | .651 | OTC | First Boston |
| 2/4 | FBC Mortgage Securities Trust XI | 495.00 | GNMA CMO | 99.94% | .500 | OTC | First Boston |
| 2/6 | CMO Trust 20 | 371.25 | Col. Bonds | 100.00% | .500 | OTC | Salomon |
| 2/11 | Amstar Corp. | 335.00 | Sr. Sub. Note | 100.00% | 3.500 | OTC | Merrill Lynch |
| 2/6 | Detroit Edison Co. | 300.00 | Gen. & Ref. Bond | 98.25% | .891 | OTC | Morgan Stanley |
| 2/5 | Santa Barbara S&L | 300.00 | Mtg. Backed | 99.38% | .679 | OTC | Salomon |
| 2/10 | Kidder Peabody Mortgage Trust 4 | 282.47 | FHLMC CMO | 99.87% | .461 | OTC | Kidder, Peabody |
| 2/10 | Texas Utilities Electric Co. | 250.00 | First Mtg. | 99.60% | .879 | OTC | Salomon/First Boston/Goldman, Sachs/Prudential-Bache |
| 2/5 | Tenneco Credit Corp. | 250.00 | Notes | 99.88% | .676 | NY | Merrill Lynch/Morgan Stanley/First Boston |
| **Common Stock** | | | | | | | |
| 2/6 | Federal National Mortgage | 289.50 | | $48.25 | 2.90 | NY/MW/PC | SLB/FBC/GS/MLCM/MS/SAL* |
| 2/12 | Himont Inc. | 287.00 | | $28.00 | 5.29 | IPO (NY) | Wertheim-Schroder/First Boston/Goldman, Sachs |
| 2/13 | Quest For Value Dual Purpose Fund | 225.00 | | $12.50 | 7.00 | IPO (NY) | Oppenheimer & Co. |
| 2/12 | American Health Properties | 200.00 | | $20.00 | 6.75 | IPO (NY) | DWR/GS/SAL/SBH** |
| 2/10 | NWA Inc. | 199.50 | | $66.50 | 0.95 | NY/MW/PC | Merrill Lynch |
| 2/5 | Echlin Inc. | 147.10 | | $22.63 | 2.56 | NY | E.F. Hutton/Donaldson, Lufkin & Jenrette/Shearson Lehman |
| 2/11 | British Airways PLC | 120.10 | | $19.07 | 1.96 | IPO (NY) | Salomon/Goldman, Sachs/Prudential-Bache |
| 2/5 | Sun Distributors | 96.90 | | $5.00 | 7.50 | IPO | Shearson Lehman/Dean Witter Reynolds |
| 2/11 | Western Digital Corp. | 45.80 | | $26.25 | 4.50 | AM | First Boston/Montgomery Securities/Needham & Co. |
| 2/5 | The Musicland Group | 35.00 | | $20.00 | 7.00 | IPO (NY) | Merrill Lynch/Bear, Stearns/Donaldson, Lufkin & Jenrette |

*Source: Securities Data Co., New York*

*Sr. Sub. Deb.: Senior subordinated debenture*
*GNMA CMO: GNMA-backed collateralized mortgage obligation*
*Col. Bonds: Collateralized bonds*
*Gen. & Ref. Bond: General & refunding mortgage bonds*
*Mtg. Backed: Mortgage-backed bonds*
*FHLMC CMO: FHLMC-backed collateralized mortgage obligation*
**Shearson Lehman/First Boston/Goldman, Sachs/Merrill Lynch/Morgan Stanley/Salomon*
***Dean Witter Reynolds/Goldman, Sachs/Salomon/Smith Barney, Harris Upham*

*NY: New York Stock Exchange*
*OTC: Over the Counter*
*IPO: Initial Public Offering*
*AM: American Stock Exchange*
*MW: Midwest Stock Exchange*
*PC: Pacific Stock Exchange*

## Equipment leasing: Performance and forecast

| | $ billions | | | | % growth[3] | % | | |
|---|---|---|---|---|---|---|---|---|
| | 1984 | 1985 | 1986[1] | 1987[2] | 1978-'84 | 1984-'85 | 1985-'86 | 1986-'87 |
| Equipment leasing[4] | 74.5 | 93.7 | 95 | 97 | 18.8 | 25.8 | 1.4 | 2.1 |
| Business investment in equipment[5] | 277.3 | 303.4 | 309.5 | 321.9 | 7.7 | 9.4 | 2 | 4 |

[1] estimate
[2] forecast
[3] compound annual
[4] estimates of new lease receivables based on survey data from the American Association of Equipment Lessors
[5] private non-residential investment in producers durable equipment
Source: U.S. Department of Commerce, Washington

# Leasing OK . . .

*Continued from page 47*

Although the report said loss of tax advantages would shrink the leasing industry's growth to 2.1% between 1986 and 1987, Commerce Department economist M. Bruce McAdam now believes that figure should be doubled because of the industry's strength so far this year.

That growth rate still is almost half of the 8% increase in leasing volume predicted for this year by the American Association of Equipment Lessors.

The alternative minimum tax, which discourages some companies from owning equipment, has invigorated the leasing industry more than expected, Mr. McAdam said.

Still, the big-ticket end of the industry has been slow to feel the beneficial effects of the alternative minimum tax, said Bruce E. Walenczyk, a vice president in the lease financing group at Kidder Peabody & Co., New York.

Until corporate executives "get their arms around the whole situation, they just are not going to be spending money on new capital acquisitions," he said.

Middle-market lessors — those that lease equipment with a purchase value of less than $5 million — offered a brighter view. "We are busier than we have ever been," said W. Randall Dietrich, manager of capital funding at Republic Financial Corp., Denver, which is a middle-market and big-ticket lessor.

"We've had companies that in the past have not leased and have now said that it makes sense for them to lease because they are going to be in the AMT . . . so their lease vs. buy decision, which before said buy, now says lease," Mr. Dietrich said.

Equipment ownership generates accelerated depreciation deductions that are treated as tax preference items, which are added to a company's ordinary income to determine federal tax liabilities under the alternative minimum tax.

Under the Tax Reform Act of 1986, corporations must pay the AMT if that tax bill is higher than the one produced under the calculations for the ordinary tax.

The amount of the preference item from depreciation is set by calculating the difference between the current tax law's double-declining balance method and the 150% declining-balance method used in prior legislation, according to a brochure published by General Electric Credit Corp., Wilton, Conn.

In addition, half of the excess of book income over tax income will be a tax preference. The less generous depreciation typically used in calculating book income creates more exposure to the alternative minimum tax.

Treasurers have become more involved in the decision to lease because of the AMT, said Robert A. Bardagy, executive vice president for marketing at Comdisco Inc., Rosemont, Ill.

Before tax reform, Comdisco — a lessor of high technology equipment — dealt mostly with the customer's computer specialists, Mr. Bardagy said. "Suddenly we have a situation now where our thrust is to the CFO as opposed to the technical side of the house."

Concern about the AMT takes second place as a reason for leasing in the airline industry, said Douglas B. Swets, treasurer of Western Air Lines Inc., Los Angeles. The company leases slightly less than 50% of its planes.

Western leases to get tax advantages it can't obtain by buying equipment, Mr. Swets said, explaining the company's net operating loss carryforwards prevent it from using tax benefits as rapidly as some lessors. Those tax benefits are passed through to Western in the form of lower rental rates.

A recent $121 million leveraged lease of six Boeing 737 aircraft, in which Westinghouse Credit Corp., Pittsburgh, put up a third of the amount as equity, resulted in a financing cost of 6.5%, rather than the 10% that Western would otherwise pay if they'd bought the aircraft, Mr. Swets said.

The debt in this 1986 deal came from U.S. life insurance companies and European banks, Mr. Swets said.

In a leveraged lease, the lender provides debt on a non-recourse basis to the lessor, which provides the equity layer of the transaction. The lessor's equity interest in the asset provides access to tax benefits of ownership that are passed through to the lessee in

*Continued on page 49*

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# Corporate notes

## Takeover debt grows

NEW YORK — In spite of some predictions to the contrary, the Federal Reserve Board's crackdown last year on junk bond-financed takeovers did little to curb high-yield financing or the takeover phenomena.

According to a report by Morgan Stanley & Co., New York, acquisition-related issuance continued to be a major contributor to new high-yield debt issuance in 1986, but non-acquisition-related financing made up most of the activity.

Dollar volume for acquisition-related junk bond deals more than doubled to $14.7 billion from $6.2 billion in 1985.

At the same time, high-yield issuance unrelated to acquisitions closed the year at $21.4 billion, up from $10.1 billion in 1985.

While volume surged on an absolute basis, Morgan reported acquisition-related deals constituted only a slightly greater portion of overall junk bond issuance last year than it did in 1985 — 40.7% vs. 38.2%.

Financings outside the takeover arena made up 59.3% of total volume, down slightly from 61.8%.

The Fed ruled in December 1985 that margin rules would apply to certain kinds of high-yield financed takeovers. Effective Jan. 1, 1986, junk bonds issued by an acquirer's shell company could not be used to finance more than 50% of a takeover transaction.

Although some at the time predicted the ruling would be a severe blow to the high-yield bond business, others, including Morgan Stanley, noted the Fed granted enough exceptions to allow other means of launching acquisitions with the help of high-yield bonds.

The Morgan report supports the firm's 1985 contention that the Fed ruling would not slow the pace of junk bond financing or merger activity.

"Takeovers are not the whole story in the high-yield bond market," said Martin Fridson, Morgan's manager of credit research.

Likewise, high-yield bonds are not the whole story in the takeover arena.

The report points out acquisition-related issues made up less than 10% of the $188.6 billion of total merger and acquisition volume last year. Only a portion of the $14.7 billion high-yield volume stemmed from hostile transactions, it stated, dispelling the view that junk bonds in the hands of hostile suitors have been responsible for merger mania.

"Whether mergers are good or bad, from a public policy standpoint, speculative-grade bonds do not deserve the bulk of the credit or blame for the boom," the report asserts.

Morgan Stanley's numbers do not include low-rated debt created from large recapitalization efforts by such companies as Colt Industries Inc. or Owens-Corning Fiberglas Corp. Since such transactions may have been motivated by a desire to avoid hostile bids that could have been financed through the high-yield market, the report concedes low-rated bonds probably played a greater role in corporate restructuring last year than in prior years.

But acquisition activities by highly rated companies also continued to be important in the trend toward industrial consolidation and increased corporate leverage.

More than half of the multibillion-dollar deals in 1986 stemmed

*Continued on page 50*

## Leasing . . .

*Continued from page 48*

the form of lower rental rates.

Mr. Swets said 100% financing ranked as another important reason for leasing, and off-balance sheet financing offers a third — but less important — reason.

Leveraged leasing gives companies with weak credit ratings the ability to gain access to large amounts of capital if they have strong cash flows, said Donald R. Kendall, a managing director in the leasing unit at Drexel Burnham Lambert Inc., New York.

The Alamito Co., Tucson, Ariz., a supplier of wholesale power, last year refinanced a $707 million electric power generating station with a leveraged lease in which Drexel served as the agent. Lenders were willing to finance the $513 million debt portion of the transaction because Alamito has a contract to sell power to the Tucson Electric Power Co., Mr. Kendall said.

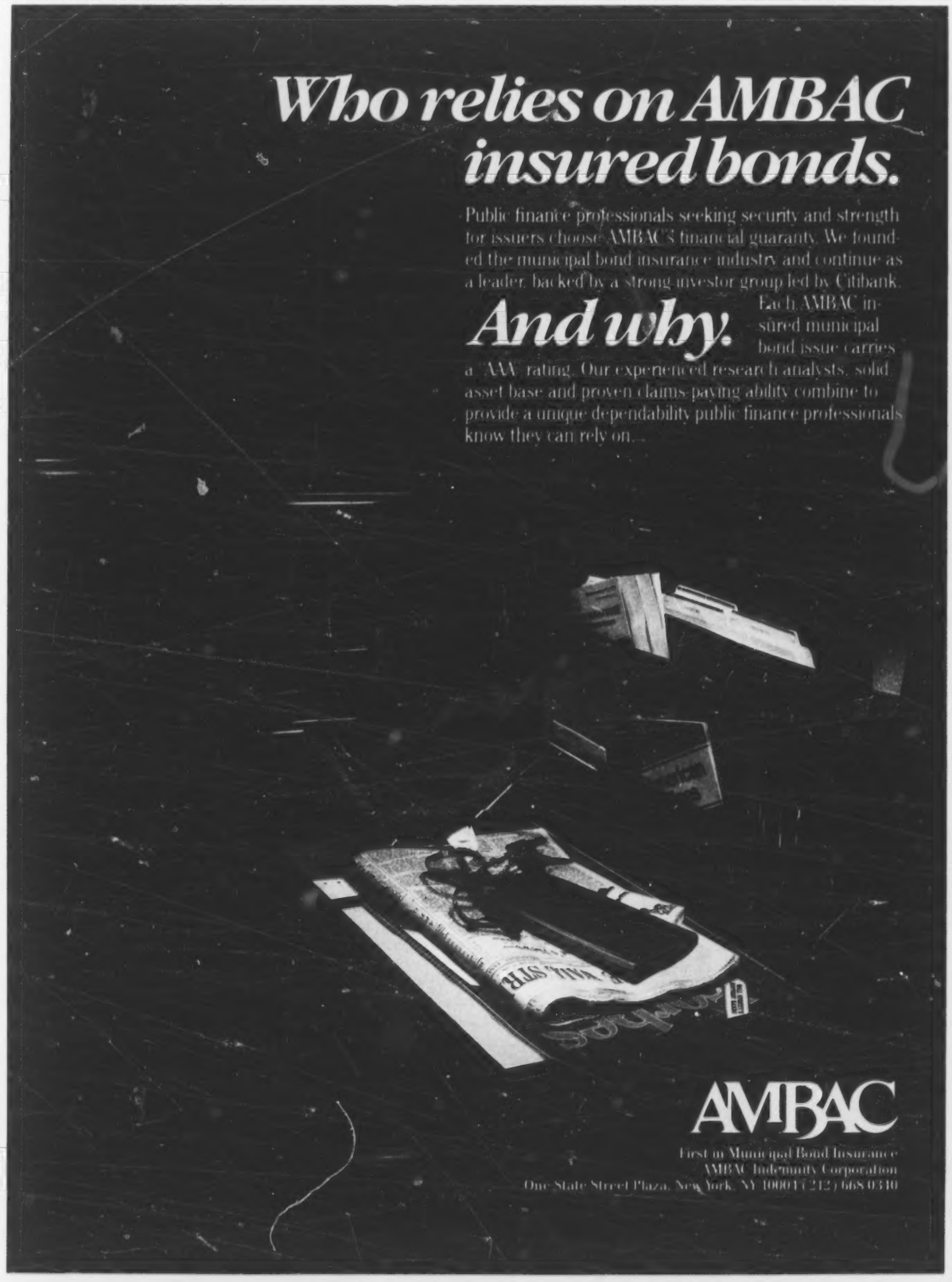
Leasing enabled The Williams Cos., Tulsa, Okla., to build a $100 million fiber-optic cable from Fairfax, Kan., to Salt Lake City. Because Williams had below-investment grade credit ratings, "the public markets did not offer an attractive alternative," said William J. La Croix, Williams' treasurer.

The January 1987 leveraged lease and sale-leaseback of the fiber-optic system, in which The CIT Group, New York, provided the equity financing, provided a boost to Williams because the company had the use of the $100 million after the sale and leaseback, said Stephen C. Rosenberger, a project manager with The CIT Group. The CIT Group is the leasing subsidiary of Manufacturers Hanover Corp., New York.

Typically, in a sale-leaseback, the lessor can use the asset's tax benefits more efficiently than the end user, which benefits from rental rates that reflect the tax advantages enjoyed by the lessor.

Lessors can add value irrespective of the tax characteristics of a deal because they know the equipment being financed better than other sources of capital, said Craig H. Raddatz, a vice president in the equipment financing group at Heller Financial Inc., Chicago. "We can turn the credit around faster than somebody who doesn't understand the industry."

He also cited long financing terms and variable payment streams as other advantages of leasing. ■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# Money mover scorecard listings corrected

## Most new business portfolio insurance

| Company | $ mils. |
|---|---|
| Wells Fargo Investment, San Francisco | 7,505 |
| J.P. Morgan Investment Mgmt., New York | 3,460 |
| Bankers Trust—Invest. Mgmt., New York | 2,083 |
| Skye Investment Advisors*, Cupertino, Calif. | 840 |
| RepublicBank Dallas, Texas | 800 |
| Oppenheimer Capital, New York | 425 |
| BEA Associates, New York | 309 |
| Advanced Investment Mgmt. Inc., Pittsburgh | 205 |
| Northern Trust Co., Chicago | 120 |
| Boston Co., Mass. | 100 |
| Citicorp Investment Mgmt., New York | 100 |

* Provides portfolio insurance for RepublicBank, Dallas

Two tables printed in the Feb. 9 Scorecard issue were incomplete. On the portfolio insurance table, data for J.P. Morgan Investment Management Inc., New York, was entered incorrectly. On the real estate equity table, Equitable Real Estate Investment Management Inc.'s data was omitted inadvertently.

## Most new real estate equity business

| Company | $ mils. |
|---|---|
| Heitman Advisory Corp., Chicago | 900 |
| Equitable Real Estate Investment Mgmt. | 814 |
| Copley Real Estate Advisors, Boston | 775 |
| Aetna Life & Casualty, Hartford, Conn. | 511 |
| TCW Realty Advisors, Los Angeles | 317 |
| Richard Ellis, Chicago | 301 |
| Jones Lang Wootton Realty, New York | 300 |
| JMB Institutional Realty, Chicago | 261 |
| J.W. O'Connor & Co., New York | 260 |
| Eastdil Realty, New York | 243 |
| La Salle Advisors, Chicago | 239 |


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# Sasco trio begins to see payoff

FAIRFIELD, Conn. — Leaving the security of IBM Corp. to strike out on their own has worked out well for three of the partners of Sasco Capital Inc., which now has three clients and more than $600 million under management, and three more clients about to sign contracts.

The three — Lee Garcia, Daniel Leary and Bruce Bottomley — who ran IBM's internally managed equity assets, and Daniel Sullivan, who departed Rollert & Sullivan Inc., launched their own money management firm just over a year ago.

Armed with IBM of Stamford, Conn., as its first client, Sasco was able to avoid many of the growing pains a start-up normally experiences. The foursome also shared the same investment philosophy and worked well together.

But mastering the mysteries of marketing was another challenge altogether.

"Getting our names and faces out there — the cold calls and the initial personal contacts — it was an adjustment," Mr. Leary said.

Added Mr. Garcia, "Learning how to approach the marketplace was the most difficult part of the startup. We were used to being portfolio managers, not marketers."

Today the firm has more than $600 million under management, and three accounts, including IBM and General Dynamics Corp., St. Louis. Three more corporate accounts will be on board before the end of the second quarter, Mr. Garcia said, but he declined to identify them.

"We're well ahead of where we thought we'd be after one year," he added.

Sasco holds about 30 companies in its portfolio. Its dynamic value philosophy is centered on spotting companies in transition, financial underachievers that can benefit from redeployment of assets. Unlike traditional value managers, Sasco isn't interested in price-earnings ratios and quarterly earnings.

"We are more event driven," Mr. Garcia said.

The firm uses proprietary software developed at IBM that screens companies with sizable investment gaps. And the partners spend a good deal of time talking with senior management.

In 1986, Sasco somewhat underperformed the Standard & Poor's 500 stock index and so far this year, it is modestly trailing the index. Less than 40% of Sasco's portfolio comprises S&P companies. "Ours is very much a non-market portfolio," Mr. Garcia said. ■